Energy Users Rule Change Committee
C/o Brian Green,
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Australian Paper
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Mr Richard Khoe
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Australian Energy Market Commission
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By email : Richard.khoe@aemc.gov.au

Dear Richard

The Energy Users Rule Change Committee ("the Committee") has considered the many submissions that have been made to the AEMC in response to the AEMC's Issues Paper on the Committee's rule change proposal.

The Committee will be developing a full response to issues arising from those submissions in due course. At this point however, the Committee wishes to respond to two specific points raised in the submissions from the New South Wales Treasury and the Queensland Treasury Corporation. The attachment to this letter is the Committee's response to those points.

It should be noted that this response is from the members of the RCC, with the exception of Rio Tinto, which was not in a position to complete its assessment by the time of this response being submitted. Rio Tinto's preliminary assessment is that the analysis presented by the Committee appears reasonable and supports the proposition that the NSW Treasury and Queensland Treasury have not provided adequate evidence or arguments to dismiss the Committee's rule change proposal

The Committee requests that the AEMC takes account of this submission in its consideration of the Committee's rule change proposals.

Yours sincerely,

B. Green

Brian Green
Chairman, Energy Users Rule Change Committee

Energy Users Rule Change Committee Response to NSW Treasury claims of Distribution Network Service Provider (DNSP) Return on Equity of 5.5% in 2010

In response to the Committee's proposal, the New South Wales Treasury Corporation has claimed that the return on equity that the Government received in respect of its investment in its three DNSPs was 5.5% in 2010. This compares to a return on investment on the sum of the distributors and retailers of 16.5% (in 2010) as calculated by the New South Wales Auditor General, and as the Committee noted in its proposal.

The Treasury's claim is significant. If it can be sustained, then it suggests that the NSW Government is in fact achieving a low return on its investment in its DNSPs, in fact significantly lower even than the price of the debt that it provides to these distributors. If this is indeed the case then this undermines the case for changes to the arrangements for the regulation of debt costs, and indeed more broadly it undermines the case for broader regulatory reform.

The Committee has considered the claims that NSW Treasury has made and has come to the view that its claim is not robust. The sub-points of this paragraph explains why the Committee has come to this view.

a) First the Treasury's claim is inconsistent with the financial information provided by the DNSPs to the Australian Energy Regulator (AER) on the performance of the regulated network businesses. The AER published a report on the NSW distributors in 2010, reflecting these data[1]. The AER's report showed that these distributors delivered an actual return on assets of 8% on average (weighted by the regulated asset bases). This is 10.1% higher than the 7.3% return on assets that the AER had expected in 2010 when it determined in its five year price control decision the previous year. The 7.3% expected return on assets reflected a regulatory allowance for return on equity of 11.8%. Assuming (conservatively) that the 10.1% return on assets outperformance of the NSW DNSPs in 2010 is proportionately reflected in the return on equity, the actual return on equity for 2010 would be 13%. This can be considered a lower bound - improvements in rates of return on assets will have a disproportionately higher impact on the return on equity as a result of the leverage achieved through the circa 75% gearing of the distributors.

[1] ACT and NSW Electricity Distribution Network Service Providers Performance Report for 2009-10

b) Secondly, the Treasury's claim that the net profit after tax on its DNSPs of $218m is equivalent to a 5.5% return on its investment, means that it must have achieved a 235% return on equity in its retail business. This is explained as follows:

1. Treasury has valued its equity in its DNSPs at $3,960m. The $686m net profit after tax in 2010 which the NSW Audit General says is equivalent to 16.5% return on equity, means that the Government's total equity in its DNSPs and retailers is valued at $4159m.
2. The difference between these two ($4,159m less $3,960m) is $199m, which is the implicit value of the Government's equity in its retail businesses.
3. In its submission to the AEMC, NSW Treasury has claimed to have derived a profit after tax of $469m on this investment in 2010.
4. This is equivalent to a return on equity of 235% on its retail business.
5. This compares to the Treasury's claim that it earned a return on equity of just 5.5% on network services.

This seems to be implausible and possibly suggests that an allocation of shared costs between the DNSPs and their retailers that is inconsistent with the financial information provided by the DNSPs to the AER.

c) Third, while the Committee has no reason to suggest that NSPs have incorrectly calculated net profits after tax, common costs and assets can be divided between distribution and retail in different ways and this affects the calculation of the profitability of each of these businesses. The NSPs published information on the split of profits between distribution/retail for the first time in 2011 – the year that the retail business was split from the regulated distribution business, and sold to private owners. This profit information was presented, typically, in a note to the accounts under the heading "financial performance of operations disposed". These notes only disclosed a summary statement of profitability. Segmented accounts were not presented for cash flows, the full profit and loss statement or the balance sheet. In the absence of an explanation of how common costs and assets have been divided between distribution and retail it is not possible to be confident that the stated split satisfies commonly accepted cost accounting principles for the allocation of common costs. In addition, we understand that as part of the privatisation of its retailers, the Government promised that there would be no forced redundancies. As a result of this, some staff previously employed by the retailer but not employed by the new owners of the retail businesses are now employed by the NSPs and hence reflected in NSP costs. This results in a reduction in NSP profits at the expense of an improvement in stated retailer profits). However this is effectively a subsidy that distributors are being required to bear in order to satisfy the Government's privatisation policy requirements. The resulting calculation of the profitability of the NSPs, while correctly reflecting the costs that the NSPs are being forced to bear, does not correctly reflect the underlying profitability of the network business to the government.

d) Fourth, the data provided in the distributors' 2011 annual reports shows inexplicable inter-annual variation, compared with the 2010 annual report. For example in 2010, the reports show that the DNSPs provided less than one third of the total DNSP plus retailer after-tax profit, with the retail business accounting for the remaining two thirds. By 2011 this had switched around so that after-tax profits of the NSPs were now two thirds of the total – almost double their 2010 after-tax profits. On the basis of the Treasury's calculation, the return on equity from its DNSPs in 2011 rose to 10.6% compared to 5.5% in 2010. For some DNSPs – such as Ausgrid - the 2011 after tax profits is more than triple the 2010 after tax profits. Such significant annual profitability variation is difficult to understand in fundamentally stable and predictable businesses as the DNSPs are. Again this might be explained by the treatment of allocation of costs and assets associated with the separation and sale of the retailers. Again this undermines the confidence that can be placed in the profitability figures in the annual reports as being indicative of the on-going profitability performance of the DNSPs.

For these reasons we suggest that reliance can not be placed on the stated return on equity of 5.5% in 2010 as indicative of the profitability of the DNSPs.

In view of the absence of sufficiently robust data in the published accounts on the actual financial performance of the DNSPs, the Committee suggests that the AEMC should rely on the information on DNSP financial performance that the AER publishes. The AER's publication is based on data provided to it by the DNSPs.

This information, for 2010, is published in the AER's annual report "ACT and NSW Electricity Distribution Network Service Providers Performance Report for 2009-10". We encourage the AEMC to ask the AER to release the relevant financial information for 2011 as soon as possible so that the AEMC can consider this information for the purposes of the Committee's rule change proposal.

In particular, as noted earlier, on average the DNSPs approximately doubled their after tax profits in 2011 compared to 2010. Ausgrid in particular more than tripled its after tax profits and return on equity over this period. Ausgrid's estimated return on equity for 2010 based on the data Ausgrid provided to the AER is estimated to be 11.8%. Since Ausgrid more than tripled its after tax profits between 2010 and 2011, it might be reasonable to expect that the calculation of their return on equity based on their regulatory accounts would also triple from the stated levels in 2010, In this case, Ausgrid's 2011 return on equity would be at least 35%.

On the basis of the information and analysis in this note we conclude that Treasury's statement that the return on equity on its distributors is 5.5% can not be accepted as a robust estimate of the profitability of these businesses. We call on the AEMC to analyse the profitability of the NSW distributors based on the regulatory information published by the AER.

Energy Users Rule Change Committee Response to Queensland Treasury Corporation's (QTC) claim of potential errors in the Committee's rule change proposal

Under a heading in its response entitled "Potential errors in EURCC analysis", QTC has said that it considers that the Committee has significantly overstated the difference between the swap issue margins in Table 5 of its proposal and the average Debt Risk Premium (DRP) awarded by the AER. Specifically, QTC's analysis suggests that this difference is actually around 50 basis points, and that the Committee's analysis implies a difference of 204 basis points. From this the QTC concludes that the Energy Users Rule Change Committee has not provided sufficient evidence to support its claims of over-compensation. QTC further suggests that more detailed analysis is required before any changes that have the deliberate effect of reducing the DRP can be considered.

The Committee has considered QTC's rebuttal and contends that the analysis and conclusions in its rule change proposal are robust against this rebuttal. This section explains the Committee's position.

QTC's analysis of this aspect of the Committee's proposal consisted of the following steps:

1. QTC presented the swap issue margins for the bonds in our Table 5 as we had presented them in this table based on data supplied by Credit Suisse.
2. QTC then calculated what it considered to be the Debt Risk Premium (DRP) based on the spread on 10 year Commonwealth Government Securities (CGS). In doing this they used price data provided by Bloomberg for both swap rates and CGS, at the date of issue of the bonds in Table 5. The outcome of this calculation was QTC's estimate of a DRP (based on the bonds in Table 5) of 278 basis points.
3. QTC then compared this estimate of the DRP with the DRP based on AER draft or final decisions that were made in the same period as the bonds/loans in Table 5. QTC claims that this is 330 basis points. So the difference, according to QTC, is 52 basis points (330 minus 278).

QTC then compared this difference (52 basis points) to the difference implied by the Committee's analysis (which is 204 basis points) and concluded that the Committee had over-stated the difference between the swap issue margins in Table 5 of the Committee's submission and the average DRP awarded by the AER.

We have replicated QTC analysis, but instead of using data supplied by Bloomberg (as QTC has done) we have used the publicly available data provided by the Reserve Bank of Australia contained in their Table F1 (on swap rates) and Tables F16 and

F16hist (on indicative mid rates of selected Commonwealth Government Securities). These tables are available from the RBA's website. From these tables we have selected the daily rates for bonds that mature in 10 years (or as close to 10 years as possible) from the date of issue of the bonds in Table 5. We consider that the Reserve Bank of Australia is a reliable data provider, not least considering their considerable expertise in both money markets and bond markets. As a consequence we suggest it is reasonable to rely on their published price data.

We compared the estimates of the swap rates and CGS rates between Bloomberg and the RBA. Bloomberg typically had higher swap rates than the RBA and lower CGS rates than the RBA. As a result of this difference:

- QTC's calculation was that the 181 basis point margin on swaps in Table 5 translated, using their data, to a 278 basis point margin on CGS.
- The Committee's calculation, using the RBA's data is that the 181 basis point margin on swaps in Table 5 translates into a 198 basis point margin on CGS.

The next step in the analysis is to consider what the appropriate estimate of the AER-determined DRP should be. QTC has suggested that it should be the AER's draft and final decisions that occurred within the date range of the bonds identified in Table 5. QTC says that this delivers a DRP of 330 basis points. The Committee has examined all the AER's (final) regulatory decisions within this data range and from this we have concluded that the average DRP is 349 basis points, not 330 basis points as QTC has suggested.

In addition, we are not convinced that it is appropriate to restrict the estimation of the AER's DRP calculation just to this date range. The Global Financial Crisis was not restricted to the date range of the bonds issued in Table 5. Indeed its effects on capital markets are still evident today As such we suggest a more appropriate range of dates to consider the appropriate AER-determined DRP would be from June 2008 (the date of the earliest issued debt on Table 5) to the present. The average DRP determined in this way based on AER decisions (some of which were recently varied by the Australian Competition Tribunal) is 3.67. Using this measure of the DRP, the difference between this DRP and our calculation of the implicit DRP for the debt in Table 5, is 169 basis points. This compares to what QTC estimates to be the difference of 52 basis points. In summary, the difference between the QTC's estimate and ours appears to be attributable to three factors:

- The data used for swap and CGS rates (we used the RBA and QTC used Bloomberg)
- The average DRP in the AER's decisions (where QTC appears to have made an error of calculation); and

- The date range for the estimation of the DRP (where the Committee suggests that what QTC has proposed is inappropriate).

Furthermore, we note that this approach only delivers a single, point, estimate. The Committee suggests that a more valid approach in analyses such as these with many independent variables and considerable uncertainty of these variables, is to consider a reasonable range of estimates. In the period since June 2008, the AER has determined DRPs in their electricity and gas network service provider decisions that have ranged between 2.93 (for Jemena gas distribution in New South Wales) and a maximum of 4.67 (for Envestra gas distribution in South Australia – as varied by the Australian Competition Tribunal). If we used the minimum and maximum DRPs the differences between each of these and our estimate of the implicit margin on CGS of the debt in Table 5, gives differences of 95 and 269 basis points respectively. If we used the DRP in the AER's most recent decisions (those since October 2010 for electricity distributors in Victoria and for gas distributors in NSW, QLD and SA) we get a difference of 207 basis points.

In addition, these calculations reflect the full data set for the debt described in Table 5. There is reason to consider the three debt issues in Table 5 which occurred over just six days in June 2008 to be outliers. This is because such debt was issued at the peak of the liquidity crisis phase of the Global Financial Crisis when short-term money market rates in particular were driven to very high peaks from which they quickly recovered following policy action by central banks around the world. If these three bonds were excluded from the analysis, the difference (between the implicit margin on CGS for the remaining bonds in table 5, and the average DRP since June 2008) is 293 basis points.

While this may be argued to be a more appropriate estimate of the difference between the AER's DRP and the implicit margin on CGS of actual issued debt, we do not propose it. This is because the Committee may be susceptible to the claim that it has been selective in the choice of debt that it has used in its analysis. Nevertheless this analysis does suggest that the estimate of the gap between the AER's DRP determination and the DRP based on actual issued debt may plausibly be considered to be significantly higher than estimated from our calculations. Certainly it can be said that a difference as low as the QTC has concluded (50 basis points) is not plausible even using the minimum DRP that the AER has determined since April 2008.

The conclusion that the Committee draws from this is that the analysis that it presented in Table 5 and the implications the Committee has drawn from that analysis are robust. Accordingly the Committee rejects QTC's rebuttal.

Finally, the Committee would like to draw attention to its view that the relevant issue is the total cost of debt, not the DRP. An analysis of the DRP in isolation of the risk free rate on which it is based (whether the bank bill swap rate or CGS is used in estimation of the risk free rate) provides only part of the picture. While the Committee has provided this detailed rebuttal of QGC's claims for the purposes of defending the analysis that the Committee has set out in its proposal, the Committee suggests that the relevant issue is a comparison of the (total) cost of debt compared to the AER's determination of the allowed (total) return on debt.