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Dear Paul

Re: ERC0134Economic Regulation of Network Service Providers, Sydney Forums and Consultation Notice

Thank you for the invitations to the workshops on consultant reports and the cost of debt, held in Sydney on 9th and 18th May 2012, respectively. We found the discussions useful and constructive. We have given some thought to a number of issues that were raised in the workshops and in this letter we set out our perspectives on four of these issues:

1. The importance to be placed on the actual borrowing practices of NSPs;
2. The use of rolling averages for risk free rates and debt margins;
3. Transitional arrangements; and
4. Discretion for choice of methodology.

We then respond briefly to the AEMC's 21 June Consultation Notice in response to the submission from the Queensland Treasury Corporation in Part B of this response.

Part A

1. What importance should be placed on the actual borrowing practises of NSPs ?

Network service providers, including ETSA, Citipower and Powercorp, have argued that the design of the rules for the return on debt should reflect their actual borrowing practices. We recognise the value of understanding NSP borrowing practices. However we are concerned that undue weight should not be placed on this in deciding any changes to the rules for the return on debt.

Our unwavering perspective is that the AEMC's consideration of the AER / Energy Users Rule Change Committee's (EURCC) proposals should be driven by the long-term interest of consumers. In the case of the allowance for the return on debt, we find it hard to see why the debt raising and risk management practices of the NSPs is any more relevant to the design of the relevant rules than, say, their transformer procurement practices are to the design of capex expenditure controls.

To the contrary, we suggest that the rules for the calculation of the return on debt should quite explicitly not be based on the borrowing practices of the NSPs. NSPs should have the incentive to minimise their borrowing costs and financial risks, both for themselves and their end use customers. The regulation should seek to achieve that, and should not be driven by NSPs' desire to manage and minimise their regulatory risks. NSPs should be encouraged to innovate and search for better ways to manage risks, reduce costs and seek greater network reliability, and for the benefits of these improvements to be ultimately passed through to consumers.

We suggest three factors that the AEMC might have regard to, in assessing the long term interest of users in the design of arrangements for the return on debt:

- **Incentive to finance efficiently:** The arrangements should ensure that NSPs have an incentive to reduce borrowing costs and risks at all times. They should not be guided or constrained in their borrowing practices by the regulatory formulation for the return on debt;
- **Ability to finance investment requirements:** The allowed return should be sufficient to ensure that NSPs are able to finance their necessary expenditures, but not more than that. Excessive allowed return on capital will incentivise NSPs to expand their asset bases to maximise their returns, as the Energy Users Rule Change Committee has suggested. We remain very wary of a regulatory approach that allows "efficient costs plus a bit." WE have heard this sort of language in a range of settings and believe that the seeming AEMC acceptance of a margin on top of efficient costs is both not in consumer best interest and lacks the level of transparency that is needed;
- **Constraints on windfall gains and losses**: Fixing the return on debt for some period establishes an incentive for NSPs to reduce borrowing costs. However it also, unavoidably, creates the prospect of windfall gains or losses if the fixed rate is different to the actual rate during the regulatory period. The benefits of incentives to minimise costs needs to be traded-off against the detriment of excessive windfall gains or losses that might consequently arise.

We understand that SFG consulting is undertaking some further work in examination of cost of debt and modelling various options.

<u>Most importantly we suggest that it is essential that in the AEMC's examination of this issue, both through consultants and AEMC's own work, that it considers the impacts of different options, in terms of their impact on regulated revenues and prices paid by end consumers, and that such impacts be disclosed in the AEMC's analysis and feature prominently in the AEMC's evaluation.</u>

2. Should rolling averages apply to both the DRP and risk free rate ?

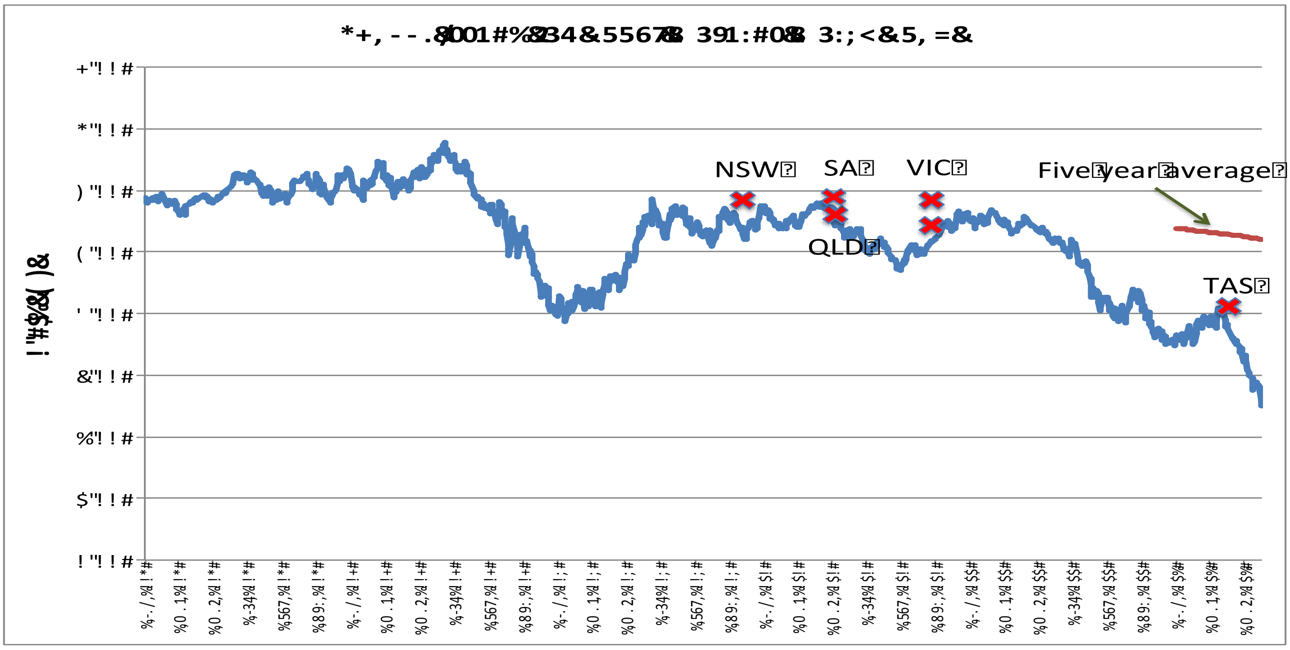
Some of the NSPs supported the use of a rolling average to set some aspects of the allowed return on debt. For example, ETSA argued that the rolling average should only be applied to what it called the debt margin (the difference between the variable cost of debt and the fixed underlying interest swap rate, which they envisaged would be set at the time of the price control determination). The AEMC has generalised this in asking for views on whether the rolling average approach should apply to the whole cost of debt, or just to some part of it such as the debt risk premium or risk free rate.

We suggest that the rolling average should apply to the full cost of debt for two reasons. Firstly the DRP is a derivative measure and is not directly measureable (it is established as the cost of debt less some calculation of the risk free rate). Sometimes the DRP is stated as the difference between the yield to maturity at issue less the 90-day bank bill swap rate rate. Others have defined it to be a bond's yield to maturity less a fixed swap rate over the term of the bond (which typically adds a small premium to the 90 day BBSW). In the National Electricity Rules it is defined to be a premium on a risk free rate which is described as he yield to maturity on 10 year Commonwealth Government Securities. Depending on the chosen measure of the risk free rate, so the measure of the DRP will vary. We are concerned that continued separation of the DRP and risk free rate will perpetuate this measurement problem. This undermines a clear understanding of the debt risk premium and, we suggest, has created the opportunity for rent seeking by NSPs in their proposals to the AER and their arguments to the Australian Competition Tribunal (ACT). This can be avoided by simply focussing on the cost of debt, rather than subjectively defined elements of it.

Secondly, the use of a rolling average means that the allowed return on debt will more accurately reflect the actual cost of debt during the regulatory period and this is particularly important at times of extreme market volatility, such as is currently evident. This issue is explored in further detail in Figures 1 and 2.

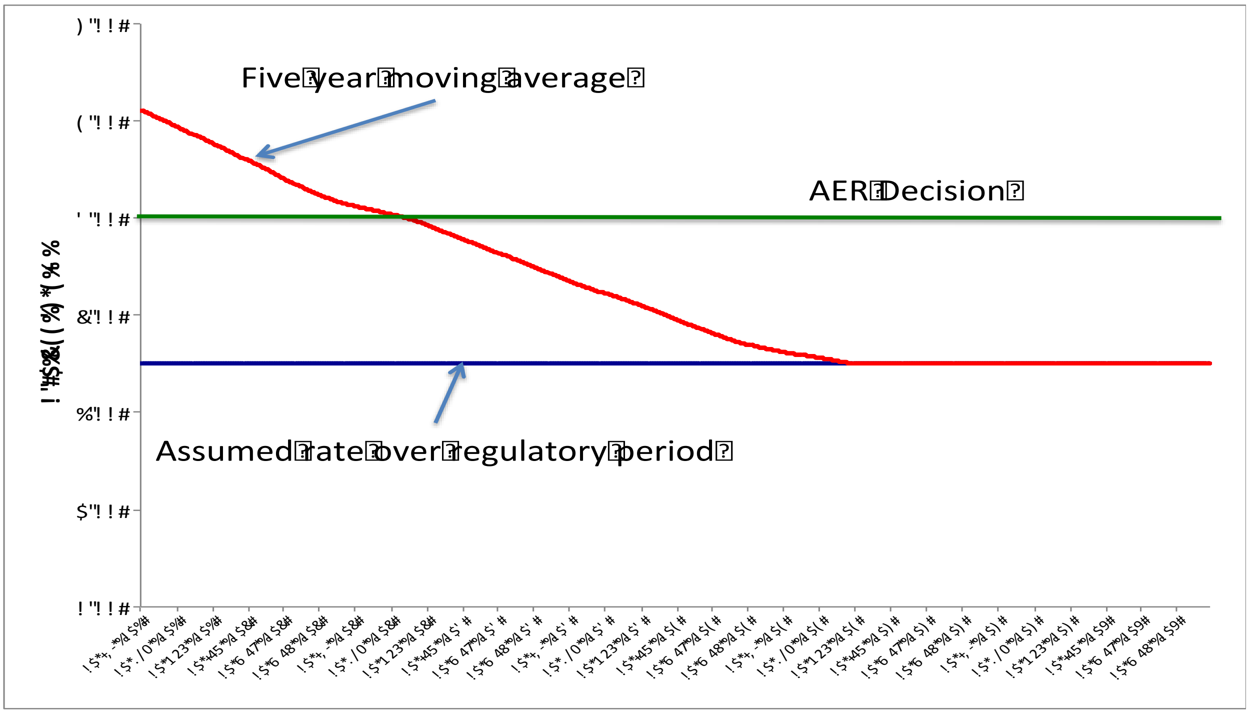
Figure 1 shows the daily yield of Commonwealth Government Security TB122. The red crosses show the Risk Free Rates (RFR) determined by the AER (and the ACT in the case of the NSW distributors) for distribution NSPs in each state. The red curve at the far right of the figure is the five-year moving average of the daily yields (it could not be extended further to the left because TB 122 was only issued in January 2007). It is clear from this figure that the current risk free rate (2.5%) established as the yield on this bond, is significantly below the circa 5.8% risk free rate determined by the AER and ACT for distributors in NSW, QLD, SA and VIC. Electricity users are being charged a far higher return on debt than would be the rate that NSPs are able to raise new bonds. This is a windfall gain for these NSPs, at the expense of energy consumers.

Figure 1. Actual risk free rates compared to AER and ACT decisions



The use of a rolling average calculation for the return on debt would still deliver a windfall gain, but the windfall would be smaller. This is illustrated in Figure 2 with reference to the AER's decision for Tasmanian distribution NSP, Aurora.

Figure 2. Hypothetical illustration of rolling average risk free rate for Aurora



For the purposes of this illustration we have assumed that the actual RFR for the five year regulatory period is 2.5% - the current average yield on the 12 year Commonwealth Government Security TB122. The AER's recent decision for Aurora set a risk free rate for the five years of the regulatory control period of circa 4%. This gives a cumulative "excess" allowed return on equity and debt to Aurora of 5 years times 1.5% (i.e. 4% set by the AER less 2.5% risk free rate – assuming current risk free rates hold for the rest of regulatory period) which equals 7.5%. If, however, a five-year rolling average is used in setting the RFR, the cumulative excess allowed return reduces to 4.5% (the area of the triangle bounded by the red line, blue line and the y-axis). This reduction in windfall gain will significantly reduce electricity prices.

The same outcome (reduced windfalls) would, of course, also result if, hypothetically, the actual interest rate was higher than the risk free rate that the AER allowed.

In the context of the extreme variability that is currently being observed in both risk free rates and the debt risk premium we suggest that the use of rolling averages is essential.

3. Transitional Arrangements

The focus for all aspects of this rule change proposal should be guided by the long term interests of consumers, not to simply smooth the way for the NSPs for any regulatory changes. We can see no sound reason to justify transitional arrangements.

Should the AEMC however, consider that transition arrangement are justified, then any transition arrangements that are considered need to be considered with direct consumer perspective input and engagement.

4. Should NSPs and the AER have discretion to choose the approach?

The AEMC has canvassed the issue, in response to NSP submissions, that NSPs or the AER might have discretion to choose the approach to the calculation of the return on debt. There can be no doubt that if NSPs had the discretion to choose, they would choose the approach that maximises their profitability. It is not clear what is to be gained from allowing discretion, other than obtaining evidence of the approach that NSPs suggest is most beneficial to them. The arrangement would also put the AEMC in the invidious position of having to specify alternate approaches and to develop Rules for how the NSPs are to exercise their choice between these approaches during a price control review. This seems to add additional complexity for no good reason and hence we suggest that the issue of NSP discretion to choose bears no further consideration. We also consider the choice of approach, appropriately communicated, is primarily the role of the regulator.

On the issue of AER discretion, the essential point is that the existing arrangements for the return on debt as specified in the Rules are clearly inadequate and on the basis of the evidence, have delivered significant windfall gains to NSPs at the expense of higher prices to users. This part of the Rules must be changed. From our perspective, while it may be prudent to allow regulatory discretion on some aspects of the implementation of the new arrangements, we suggest that the fundamental architecture – a five year rolling average of the yield to maturity on a specified cohort of bonds – should be specified in the Rules. This will provide clarity, and some level of certainty to investors and consumers.

As a final comment to this section we suggest that a 'rule of thumb' that may be applied to assessing the various considerations 'on the table' is to ask "could the price paid by consumers actually fall under this approach?" We remain concerned that the current rules as currently applied seem to lock in price rises for consumers, whereas in an effective, competitive market prices paid by consumers can fall as well as rise.

Part B

The following comments are in response to questions raised in the Consultation Notice issued by the AEMC on 21 June 2012

1. As compared to the proposal put forward by the EURCC in the rule change proposal and ETSA/ Citipower/ Powercor's proposal in response to the Directions Paper, what are the advantages and disadvantages of QTC's proposal?

We have not attempted to evaluate QTC's proposals relative to the EURCC's proposal – we do not have access to the data, or indeed the resources needed to do this. However, we are concerned about the philosophy underlying QTC's proposal. The explanation of their revised proposal indicates clearly that it has been motivated at dealing with NSP concerns. We looked for evidence or argument that their proposal sought to achieve the long term interests of consumers, but could find none. This gives us cause for concern and we reiterate the point we make earlier in this letter, that the AEMC should set rules that achieve the long term interest of consumers, not the arrangement that best insulates NSPs from debt market risks.

2. If QTC's proposal was to be implemented, how would such a move affect a NSP's current financing practices? What impact would it have on its risk management practices?

As with question 1, we are not in a position to answer this question but we reiterate our concern that the AEMC is asking a question about impacts on NSP's without the countervailing question of impact on consumers.

3. Would QTC's approach reduce the overall level of risk associated with debt financing for NSPs? If so, are there any implications for cost of equity

This purpose of this question is not clear to us. Our understanding of QTC's proposal is that it is focused on reducing the risk to NSPs where they cannot perfectly hedge the cost of debt that a rolling average calculation would deliver. We do not consider that this is a valid objective for the design of the arrangements for the regulated return on debt. The arrangements for the return on debt should be focused on setting a suitable benchmark of the efficient costs, not insulating NSP's shareholders against debt market risks.

4. What changes (if any) should be made to the approach to calculation of the cost of equity if this moving average approach is applied to debt to ensure a consistency of approach?

We agree that it is highly desirable to also address the calculation of the risk free rate in the determination of the cost of equity. If the current approach is unsatisfactory with regard to the calculation of the return on debt, then it should also be unsatisfactory for calculating the return on equity.

We have not thought about the solution to this in detail, but would have thought that a rolling-average calculation of the yield to maturity on Commonwealth Government Securities would be appropriate. The methodology illustrated in Figure 2 of this letter may be the place to start.

5. If the moving average approach is adopted, should the average be calculated based on dollar- weighted average of the rates or by calculating the effective interest rate (the IRR of all future payments on the debt) or some other method?

We are unsure which "rates" the AEMC is referring to in this question, or how the IRR of all future payments is to be calculated, and so cannot answer this question.

6. Is the proposal for re-calculating the cost of debt on a quarterly basis reasonable? What other frequency of data points (to the proposed quarterly basis) could be used in calculating the cost of debt and why would this be an improvement?

We do not have the data to answer this, but based on QTC's claim that the cost of debt is largely unaffected whether daily or quarterly measures are taken, we would assume that quarterly measures would be appropriate.

7. Should this approach be an option under the rules? If so, should the regulator or the NSP have the discretion to exercise the option and why?

We do not support the idea of optionality. If, however, the AEMC is minded to pursue optionality, then we suggest that the choice of option should be at users, not NSP's, discretion.

Should you require further comment on these comments, please contact Mark Henley, on 0404 067 011 and email: markh@unitingcommunities.org

Yours sincerely,

Susan Helyar
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