energy networks association

RETURN ON DEBT

Response to AER Issues Paper - Choice of third party service provider

19 May 2014

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OVERVIEW

The Energy Networks Association (ENA) welcomes the AER's broad consultative engagement on issues of cost of debt and the release of the Issues Paper *Return on Debt: Choice of third party data service provider* in April 2014.

The consultation is important given the materiality of the cost of debt estimation process to overall regulated revenue and pricing outcomes for consumers, the recent amendments to the *National Electricity Rules* and *National Gas Rules* in this area, and developments in available third party data sources.

The energy network sector supports consideration of third party data sources as part of assessments under the the relevant rule provisions, including the allowed rate of return objective.

The assessment of the third party data sources against the AER's nominated 'assessment criteria' in the Issues Paper, however, highlights the weaknesses previously identified by ENA in using derived criteria separate to the existing rules-based guidance to inform key regulatory implementation decisions.

The launch of the new Reserve Bank of Australia (RBA) debt series is an important development in cost of debt estimation processes, and given it is likely to be developed and specified further (for example, provided in daily form), AER processes should remain flexible to take full account of future refinements. This will allow this series and other relevant evidence such as Bloomberg data, maximum scope to serve to inform cost of debt estimates into the future.

BACKGROUND

The Energy Networks Association is the national industry association representing the businesses operating Australia's electricity transmission and distribution and gas distribution networks. Member businesses provide energy to virtually every household and business in Australia. ENA members own assets valued at over $100 billion in energy network infrastructure.

Cost of debt estimation has been highly contentious area of recent regulatory debates, due to a combination of circumstances surrounding the historic reliance on an evolving series of commercial providers' proprietary curves to derive a benchmark measure.

RBA's new debt series provides an important new data source for estimates, with the prospect of more frequent data availability over time and a capacity to publicly discuss and iteratively examine its underlying approach and assumptions to a greater degree than has been possible with commercial data providers to date.

The Issues Paper raises a number of detailed implementation questions, which this submission does not address. Rather, these issues are likely to be substantively addressed in coming regulatory proposals from network service providers. It is noted in this regard that individual network service providers have scope under the Rules to propose alternative approaches to cost of debt estimation which meet the relevant rule provisions.

ROLE OF ASSESSMENT CRITERIA

The AER proposes using its *Rate of Return Guideline* assessment criteria to inform its consideration of alternative third party data in establishing a benchmark cost of debt.

The ENA continues to have significant concerns about the role and application of the Rate of Return guideline assessment criteria in applying rule provisions and informing the AER in its decision-making functions.

Use of a second-tier or level of assessment criteria around methodologies and data sources risks obscuring the principal regulatory task of interpreting and applying the operative rules. It is an approach which involves heightened risk of error, particularly due to the scope for irrelevant considerations to find expression in the interpretation of rule requirements

As a small practical example of this, the Issues Paper does not systematically examine the requirements and implications of the key National Electricity Rules and National Gas Rule provisions which define the requirements for a cost of debt estimate (see *National Electricity Rules*, Clause 6.5.2 (h)-(l) and the identical gas provisions).

Rather, the paper discusses at length the potential application of assessment criteria which are not in many cases referable to any provision of the rules (i.e. a criterion favouring 'simple over complex' approaches).

Some of the assessment criteria, as ENA has previously drawn attention to, integrate elements of past *National Gas Rules* which were amended and removed as part of deliberate rule-making decisions (i.e. a 'well-accepted' criterion acting as a constraint incorporating information provided by alternative cost of equity models). This highlights the potential of assessment criteria to supplant and frustrate, rather than enhance, the task of interpreting and applying the relevant rules.

The actual practical application of the assessment criteria is an additional area of concern, as there does not seem to have been full or systematic consideration given to the potential issues raised under each criterion. This has the result of making the resulting analysis incomplete and anecdotal in nature.

An example of this is the application of the final 'sufficiently flexible' criteria, which in the Issues Paper is cited as relevant to the question of the frequency of alternative data. However, the same criteria is arguably equally as relevant for other questions raised in the Issues Paper, such as the potential of ensuring a methodology takes into account multiple data sources in a way that is robust over a regulatory period.

NEED FOR FUTURE FLEXIBILITY

An overarching need in current circumstances is for flexibility rather than the prescription and detailed definition of a single rule compliant approach at this time.

The development of a fully specified methodology regarding the integration of a range of direct and third party provider debt information may not be desirable in the current context of multiple overlapping transitional determinations, a range of efficient debt management practices, and whilst awaiting the final form of the new data series sponsored and designed by the Reserve Bank of Australia.

It is ENA's understanding that the RBA's new debt series is still in the process of full development (i.e. it is likely to be amended to provide daily data over time) and AER decisions around current applicable methodologies need to ensure they do not unintentionally close off the full use of this strong, independent and transparent data set.