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COMPETITION & REGULATION UPDATE

WACC: A NEW WORLD ORDER?

The Australian Energy Regulator (AER) on Friday released its *Draft rate of return guideline*, August 2013 (AER Draft Guideline). The AER Draft Guideline sets out the methodologies, models and other material that the AER proposes to use in estimating the rate of return for regulated energy network businesses, in light of recent changes to the rate of return regulatory framework.

The approach adopted by the AER is likely to have a much broader impact than just on energy network regulation, with potential implications for the pricing of regulated and unregulated infrastructure such as communications networks, gas pipelines, water pipelines, airports, rail lines and ports.

This update highlights key changes in the AER's approach to determining the rate of return as proposed in the AER Draft Guideline and considers the AER's proposed approach against the background of the current legal framework. The update also includes a table summarising the approach in the AER Draft Guideline, the approach proposed by the Economic Regulation Authority of Western Australia (ERA) (the regulator responsible for the regulation of certain gas pipelines in Western Australia) in its *Draft Rate of Return Guidelines*, 6 August 2013 (ERA Draft Guidelines) and the approaches adopted by the AER and the Australian Competition and Consumer Commission (ACCC) in recent regulatory determinations.

While much has stayed the same in the AER's approach to estimating the rate of return, there are some significant changes foreshadowed, including in particular, reduced reliance on the Sharpe-Lintner Capital Asset Pricing Model (CAPM) and the adoption of a trailing average approach to determining the return on debt. In addition, the AER has indicated that it proposes to return to a value for gamma of 0.5, rather than the value of 0.25 determined by the Australian Competition Tribunal (Tribunal) in 2011.

While the new framework gives the AER greater discretion as to the methodologies to be used in determining the rate of return and has been touted as allowing for greater levels of regulatory judgement, constraints on the regulator persist under the current legal framework. It therefore remains to be seen whether the new regime really permits the AER to deliver up a new world order for determination of the rate of return.

BACKGROUND

Recent changes to the rate of return provisions of the National Electricity Rules (NER) and the National Gas Rules (NGR) require the regulator to determine an overall rate of return that meets the 'allowed rate of return objective', which is that the rate of return for a business is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the business in respect of the provision of the regulated services. Compared to the previous NER provisions (which in turn influenced the AER's approach to estimating the rate of return under the NGR), the AER now has increased discretion as to the methodologies to be used in determining the rate of return. The changes to the rate of return framework are discussed in more detail in our January update 'Energy regulators commence rate of return review processes' (available at http://www.dlapiper.com/australia/energy-regulators-rate-of-return-review/).

Under the NER and the NGR, the AER and the ERA are required to publish rate of return guidelines that set out the methodologies they propose to use in estimating the allowed rate of return, as well as the methods, financial models, market data and other evidence they propose to take into account in determining the rate of return in the regulation of energy network businesses.

Both the AER and the ERA commenced consultation processes for their rate of return guidelines in December 2012.

ROLE OF THE GUIDELINES

In introducing the current rate of return provisions into the NER and NGR in 2012, the Australian Energy Market Commission (AEMC) indicated that it intends the guidelines to provide a meaningful signal as to the regulator's intended methodologies for estimating the allowed rate of return. In circumstances where greater discretion resides with the regulator, the guidelines are intended to offer service providers, investors and consumers with certainty on the methodologies of the various rate of return components and how the regulator will assess the relevant estimation methods, financial models, market data and other evidence in achieving the allowed rate of return objective.

While the rate of return guidelines are not binding, the NER and NGR provide that if the regulator makes a determination that is not in accordance with the guideline, the regulator must state its reasons for departing from the guideline.

However, the regulator must determine the allowed rate of return that achieves the allowed rate of return objective each time it makes a regulatory determination. That is, as noted by the AEMC, the guidelines should not be seen as a determinative instrument for calculating the rate of return. As a result, even in circumstances where the AER has foreshadowed a particular parameter value or a particular approach in the AER Draft Guideline, the AER is required to determine the rate of return that achieves the allowed rate of return objective, having regard to all relevant material then before it, each time it makes a regulatory decision. The AER must continue to establish an evidentiary basis for the approach adopted and values determined by it for the purposes of each decision and cannot rely solely on consistency with the rate of return guidelines for this purpose.

KEY CHANGES IN APPROACH

A summary of the AER's approach to the rate of return and gamma as outlined in the AER Draft Guideline, the approach of the ERA in the ERA Draft Guidelines and the approaches of the AER and ACCC in recent regulatory determinations is included in the table at the end of this update.

The key changes in the AER's approach are described below.

Overall rate of return

In accordance with the requirement in the NER and NGR to do so, the AER is proposing to continue to calculate the weighted average cost of capital (WACC) using a nominal vanilla formula. However, the AER has greater flexibility as to the methodologies to be used and will also use 'reasonableness checks' on the overall rate of return using regulatory asset base acquisition and trading multiples.

The AER has suggested that the application of its approach to determining the rate of return will lead to a more stable return over time and less volatile prices for consumers. While greater stability will necessarily arise from the use of the trailing average approach to estimating the cost of debt, other elements of the rate of return calculation must still reflect changing market conditions. In any event, we observe that 'stability' in the rate of return is not an end in itself and is not a permissible objective for the AER to pursue in determining a rate of return or in selecting the methodologies and approaches for this purpose. Rather, the AER is required to determine the methodologies and approaches and the resulting rate of return that achieve the allowed rate of return objective at the time it makes a determination. Indeed, in making its 2012 final rule determination regarding the new rate of return provisions, the AEMC expressly rejected an 'inertia' principle in determining the rate of return and emphasised the importance of a framework that is capable of responding to changes in market conditions.

Despite the increased discretion on the part of the AER in selecting the approach to determining the rate of return and the increased focus on determining the overall rate of return, an error by the AER in the determination of a particular parameter or in relying on reasonableness checks may still, having regard to all the circumstances, give rise to a reviewable error on the part of the AER. The AER is still required to make a reasoned decision on a sound evidentiary basis, and to both make a reasonable decision and exercise its discretion correctly, having regard to all the circumstances. While changes presently proposed to the merits review regime may require applicants for review to also demonstrate that an alternative decision was materially preferable in making a contribution to the national electricity objective or national gas objective (as relevant), given the significance of the rate of return to total revenue, it is not difficult to envisage scenarios in which this would be the case.

Return on equity

The AER proposes that the Sharpe-Lintner CAPM will be the 'foundation' model in determining the return on equity. However, the AER does not intend to directly apply the output from the model (as it was required to under the previous NER provisions). Rather, the AER is proposing to exercise regulatory judgement in determining the return on equity and will:

- Use both the Black CAPM and dividend growth models to inform parameter estimates (equity beta and market risk premium respectively)
- Use a range of other material to inform parameter estimates
- Use a range of other material to inform the overall return on equity (such as the Wright approach, takeover/valuation reports, broker return on equity estimates, debt spreads, dividend yield, comparison with the return on debt).

While the AER indicates that the final point estimate of the return on equity 'will require the exercise of regulatory judgement', this does not put the regulator's decision in this regard beyond the reach of potential review. The AER's exercise of discretion must be correct and the decision must be reasonable, having regard to all the circumstances and on the basis of the material before it. For instance, any use by the AER of other material such as that listed above to depart from the output of the Sharpe-Lintner CAPM, or to select a point estimate from within the range produced by the CAPM, must be correct and reasonable having regard to all the circumstances and the material before it.

The AER has not given an indication of the likely value for the equity beta or the market risk premium. While the AER does not propose to specify a value for the market risk premium in its final guidelines, the AER is proposing to include a proposed range for the equity beta, together with a point estimate it considers appropriate at that point in time. As noted above, despite specification of these values, the AER will be required to demonstrate an evidentiary basis for each element of its rate of return determination for each regulatory decision on the material then before it.

The AER proposes to select the risk free rate by averaging Commonwealth government securities (CGS) over a period of 20 business days falling between the draft and final decision, as close as practicably possible to the commencement of the regulatory period. The basis on which the AER proposes that the period be as close as practicably possible to the commencement of the regulatory period is not clear, particularly in light of the Tribunal's 2009 decision regarding EnergyAustralia in which the Tribunal held that there was no basis for the AER's practice of applying a risk-free rate averaging period closer to the start of the regulatory period in circumstances where the nexus is broken between the period for which the rate of return is applied (i.e. the regulatory control period in its entirety) and the period for which it is estimated, and that it cannot be assumed that the selection of an averaging period closer to the AER's determination would give a better estimate. The Tribunal indicated in that decision that evidence regarding future rates during the regulatory period in which the WACC is to be applied should be considered and compared to future rates during any proposed averaging period to assess whether the period would generate an appropriate return for the period in which is to be applied.

Cost of debt

In a significant shift away from the 'on the day' approach to estimating the cost of debt previously mandated by the NER (and adopted in respect of regulated gas businesses), the AER is proposing to adopt a trailing average portfolio approach to determining the cost of debt whereby:

- The length of the trailing average would be seven years
- Equal weights would be applied to each year used to determine the trailing average
- The trailing average would be updated every regulatory year within the regulatory control period.

The AER proposes to estimate the return on debt using the published yields from an independent third party data service provider. This is consistent with recent Tribunal decisions which found that the AER erred in giving weight to both the Bloomberg bond yields and an individual bond yield and warned the AER against picking and choosing individual bond yields without considering the significance of other potentially relevant bonds.

The AER is also proposing to assume a credit rating of BBB+ and to reduce the term to maturity to seven years (from 10 years). The AER intends to use an agreed averaging period of at least 10 or more consecutive business days specified for each regulatory year within a regulatory period.

Under the NER and NGR, any updating of the return on debt after the regulator's decision must be effected through the automatic application of a formula specified in the decision. That is, it cannot involve any exercise of discretion on the part of the regulator at the time the return on debt is updated.

The AER is proposing a seven year transition period from the current approach to the trailing average approach outlined in the AER Draft Guideline.

Gamma

The AER is proposing a controversial move away from the 2011 Tribunal decision regarding Energex Ltd on the utilisation of imputation credits (gamma), which decision has until now been followed in subsequent Tribunal decisions and by the AER and the ERA in regulatory determinations in the first instance. Rather than adopting a gamma of 0.25 (based on a distribution ratio of 0.7 and utilisation rate of 0.35), the AER considers current evidence leads to an estimate of gamma of 0.5 (based on a distribution ratio of 0.7 and a utilisation rate of 0.7). The AER based its estimate of the utilisation rate on the equity ownership approach, tax statistic estimates, implied market value studies and other supporting evidence including observations about market practice, government tax policy and imputation equity funds.

WHAT'S NEXT?

Submissions on the AER Draft Guideline are due by close of business 11 October 2013. The AER (and ERA) are required to publish final rate of return guidelines by 29 November 2013.

The AER suggests that its final guidelines, while not specifying the rate of return that it would determine at that time, will specify some parameters and is intended to allow regulated businesses to determine a 'starting point' for the rate of return estimate with a reasonable degree of precision.

Contact us if you have any queries regarding the consultation process or the AER's proposed approach to determining the rate of return under the revised provisions of the NER and NGR.

SUMMARY OF PROPOSED APPROACHES TO RATE OF RETURN AND RECENT DECISIONS

	AER Draft Guideline	ERA Draft Guidelines	Recent AER decision (gas, March 2013)*	Recent ACCC decision (telcommunications, May 2013)#
Cost of debt	Trailing average portfolio method over 7 years by reference to averaging period of 10 or more consecutive business days, updated annually Published yields from third party data service provider, term to maturity of 7 years Period of transition	Risk free rate + debt risk premium 5 year weighted average of bond yield estimates (Bloomberg and UBS)	Risk free rate + debt risk premium 10 year corporate bond over 20 day averaging period (extrapolated Bloomberg BBB rated 7 year fair value curve)	Risk free rate + debt risk premium + debt raising costs 20 day simple average of three Telstra bonds
Return on equity	Sharpe-Lintner CAPM (with other models and methods informing parameter estimates and overall return on equity)	Sharpe-Lintner CAPM	Sharpe-Lintner CAPM	Sharpe-Lintner CAPM
Equity beta	Point estimate to be included in final guidelines Estimated having regard to empirical evidence, the theory underpinning the Black CAPM and regulatory precedent	Estimated using ordinary least squares, Least Absolute Deviations, MM and Theil-Sen methods	0.8 A value just above the range of 0.4 to 0.7 suggested by empirical evidence	0.7 Based on benchmark estimates of equity and asset beta values for telecommunications businesses across OECD countries
Market risk premium	Estimated having regarding to theoretical and empirical evidence, including historical excess returns, survey evidence, financial market indicators and dividend growth models	Four approaches will be considered: 1) historical data on equity risk premium; 2) surveys of market risk practice; 3) qualitative information on Australian financial markets around the time of the decisions; and 4) other Australian regulators' current practice	6% Considered range of evidence: historical excess returns; academic research on excess return predictability; consultant advice; survey evidence; recent decisions by Australian regulators and the Tribunal	6% Long-term historic average MRP estimates
Gearing ratio	0.6	0.6	0.6	0.6

	AER Draft Guideline	ERA Draft Guidelines	Recent AER decision (gas, March 2013)*	Recent ACCC decision (telcommunications, May 2013)#
Credit rating	BBB+	Median credit rating approach based on publicly available rating from international rating agency of a benchmark sample of network service providers in the gas and/or electricity industry in Australia	BBB+	N/A (use of Telstra bonds)
Risk free rate	10 year CGS yields over 20 day averaging period Averaging period to be between the draft and final decisions, as close as practicably possible to the commencement of the regulatory period	5 year CGS yields over 20 day averaging period	10 year CGS yields over 20 day averaging period	10 year CGS yields over 20 day averaging period
Assumed utilisation of imputation credits (gamma)	0.5 (payout ratio of 0.7 and utilisation rate of 0.7)	Number of dividend drop-off studies for estimating theta	0.25 (payout ratio of 0.7 and utilisation rate of 0.35)	Having regard to constraints on foreign ownership, Telstra's dividend payout ratio, Tribunal decision and range of dividend drop-off studies 0.45

* AER, *Access arrangement final decision, SPI Networks (Gas) Pty Ltd 2013-17*, March 2013, Part 1, pp23-30, 38, Part 2, Attachment 5.

\# ACCC, *Public inquiry to make a final access determination for the Wholesale ADSL service, Final Report*, May 2013, pp36-39, applying the estimation methodologies used in ACCC, *Inquiry to make final access determinations for the declared fixed line services*, July 2011, pp49-76.

MORE INFORMATION

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