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4 October 2012

Mr Richard Khoe
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Australian Energy Markets Commission
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By email to: richard.khoe@aemc.gov.au

Dear Richard

Submission on AEMC Draft Determination on the economic regulation of network services

The Financial Investor Group (FIG) welcomes this opportunity to provide the attached submission on the Commission's Draft Determination on the economic regulation of network services. FIG is an affiliation of the major investors in Australian energy network assets. Its members compete for the ownership of infrastructure, including regulated energy network assets, and for investors' funds that are, or may be, seeking exposure to the asset class.

The attached submission focuses on issues relating to the regulators' estimates of the cost of capital. FIG agrees with the Commission's view that recent regulatory and tribunal decisions have adopted an overly formulaic interpretation of the National Gas Rules. Furthermore, this approach has resulted in cost of equity estimates that are unprecedentedly low, and which do not accord with capital market expectations.

Although FIG applauds the Commission's approach, we are concerned that the draft Rules would not achieve the Commission's intentions. Our submission therefore sets out improvements to the drafting of the Rules, to ensure that the Commission's intentions are given effect, and to minimise the scope for misinterpretation.

As you know, investors strongly prefer a stable, predictable regulatory framework in which regulators are accountable for their decisions. Investor confidence is an essential pre-requisite for efficient investment, which is the stated objective of the legislation. As a guiding principle therefore, FIG's proposed drafting changes are intended to promote investor confidence while adhering to the key findings of the Commission's Draft Determination.

If you have any questions in relation to the attached submission, please feel free to contact me directly on 0414 775 089

Yours sincerely

David Bartholomew
Chief Executive Officer
DUET Group

The Financial Investor Group

Submission to AEMC Draft Determination on the economic regulation of network services

4 October 2012

The Financial Investor Group

Submission to AEMC Draft Determination

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Attachment: Mark-up showing suggested changes to draft Rule 24

The Financial Investor Group

Submission to AEMC Draft Determination on the economic regulation of network services

Executive summary

The Financial Investor Group (FIG) welcomes the opportunity to comment on the Commission's draft Rule determination regarding the economic regulation of electricity and gas networks. The Commission's work is a watershed in Australian regulation because it will establish the future direction of regulation for the next 10 years or more.

Although some stakeholders believe that regulation has not been effective enough in constraining network prices, FIG does not accept that network prices are too high. In fact, recent regulatory decisions have not provided a reasonable risk-adjusted return on investment. In addition, there are currently weak incentives to commit the new capital that is necessary to maintain network performance in the long term interests of customers.

For FIG members, regulation is the single most important factor in deciding whether to invest in energy networks. Regulation cannot, however, require capital markets to fund new investment. The practical reality is that capital markets will allocate funds to competing investment opportunities according to investors' perceptions of risk and reward. Energy networks compete for funding on a level playing field with non-regulated investment opportunities and with regulated sectors in other regulatory jurisdictions around the world.

Within the regulatory framework, the *expected* rate of return is of central importance to investors. FIG emphasises *expected* return, because there is no guarantee that investors will earn the regulated cost of capital. Actual returns will depend on how the company performs against each of the building block components and the service targets.

Investors strongly prefer a stable, predictable regulatory framework in which the regulator is accountable for its decisions. FIG's view is that the Commission should consider carefully whether the overall effect of the amended Rules is to promote or diminish investor confidence. It is axiomatic that a diminution in investor confidence is inconsistent with promoting the national objectives specified in the energy legislation. Investor confidence – once lost – is not easily restored.

In preparing this submission, FIG obtained a number of specific comments from investors. The following themes emerged in relation to the cost of capital:

- Investors value consistency and predictability in regulated returns;
- Funding could readily shift away from the regulated sector to other investment opportunities, especially if perceptions of regulatory risk increase;
- Regulation should consider real-world data in setting the allowed rate of return; and
- Investors value regulatory accountability.

FIG urges the Commission to consider carefully these high-level observations as it works towards finalising its Rules in relation to the cost of capital.

In relation to the specific cost of capital positions developed by the Commission, FIG is broadly supportive. FIG particularly welcomes the Commission's view that no single theoretical model can or should be used to determine the cost of capital.

FIG's view is that regulators should employ multiple models and financial analyses, whilst ensuring that the outcomes of regulatory WACC determinations are consistent with market data and real-world market conditions. FIG also strongly agrees with the Commission that merits review provides an important discipline on regulators and thereby encourages better regulatory decisions.

The cost of capital provisions as drafted, however, would inadvertently allow the regulators to retain their existing approach to determining the WACC, which is overly formulaic and contrary to the Commission's intentions. This is a major concern to FIG because the regulators' rigid adherence to a narrow application of the Capital Asset Pricing Model (CAPM) is currently providing allowances for the cost of equity that are inconsistent with market evidence.

FIG has identified four aspects of the draft Rules that require further careful consideration by the Commission:

- There is nothing in the Commission's draft Rule to stop the regulators from continuing with their current formulaic and misguided application of the CAPM.

- The draft rate of return objective does not give appropriate weighting to market data and market evidence.

- The cost of debt provisions should more clearly express the regulatory principle that the regulator's task is to set a benchmark allowance, rather than ensure that each company only recovers its actual costs of debt.

- The draft Rule should provide more specific direction to the regulators regarding the content of the WACC guidelines, and should also include specific requirements for the regulators to explain their reasoning.

FIG urges the Commission to address these matters in its final determination. While FIG supports the Commission's intentions, the Rules as drafted will not achieve the NEO or NGO, which require the promotion of efficient investment for the long term interests of customers.

1. Introduction

FIG is an affiliation of the major investors in Australian energy network assets. FIG members have interests in well over $30 billion of Australian energy network assets, most of which are regulated. This is a substantial proportion of Australia's privately owned energy network assets, and about 40% of those subject to economic regulation.

FIG welcomes and supports many aspects of the Commission's draft Rule determination, which relates to the economic regulation of energy networks. The principal focus of this submission is concerned with the cost of capital provisions in the draft Rules.

It is important to emphasise at the outset that FIG supports improvements to the current regulatory arrangements. As the expert panel has commented[1] in respect of the limited merits review, however, it is important "not to over-turn the applecart." The Commission faces an important challenge because its decisions now will set the direction for regulation over the next 10 years or more.

FIG recognises that effective regulation depends on getting the balance right between the interests of the companies and their shareholders on the one hand, and the interests of customers on the other. In this sense, regulation should seek to encourage competitive behaviour and replicate efficient market outcomes. It must also be recognised, however, that regulation is always an imperfect substitute for competition and competitive markets.

As explained in this submission, the application of the existing cost of capital provisions has strayed from the competitive market paradigm. In particular, FIG strongly agrees with the Commission – in quoting from the Limited Merits Review stage one report – that "binding regulatory decisions hand and foot to a financial model with known defects does not immediately commend itself as an approach that will advance the NEO and NGO."

While FIG agrees with the Commission's conclusions, we are concerned that the draft Rule will not give effect to the Commission's intentions. The remainder of this submission explains our concerns and is structured as follows:

- Section 2 explains that the cost of capital estimates should be subject to an overarching market based test.
- Section 3 highlights recent cost of equity determinations, which raise significant concerns for investors.
- Section 4 comments on the draft provisions in relation to the cost of capital.
- Section 5 sets out FIG's conclusions.

[1] Review of the Limited Merits Review Regime, Discussion Paper, Issues and Questions for Stage Two, 23 July 2012, page 1

2. An overarching market based test is required

FIG members consider it essential that the Rules governing the rate of return must be directed to achieving the overarching objectives in the legislation. In particular, the National Electricity Objective, the equivalent gas objective and the Revenue and Pricing Principles, together form the foundation of the regulatory regime. Specifically, the National Gas Objective in section 23 of the National Gas Law states:

> "The objective of this Law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas."

It is worth recognising at the outset that the purpose of the NGO is not to promote the long term interests of consumers, but to "promote efficient investment in, and efficient operation and use of, natural gas services" which will, in turn, be in the long term interests of customers.

The reference to "long term interests of consumers" in the objective reflects the importance of striking the right balance between delivering lower prices in the short term, and the need to set prices at a level that will be sufficiently high to attract the new investment needed to maintain network performance and service levels over the long term.

This important consideration is reflected specifically in the revenue and pricing principle set out in section 24(6), which requires the regulator to have regard to the economic costs and risks of possible under-investment in infrastructure. In this context, FIG notes that it is widely accepted that very significant economy-wide costs are likely to be associated with under-investment in energy networks.

The other Revenue and Pricing Principles in the National Gas Law that are particularly relevant to the task of estimating the cost of capital include:

> Section 24(2) – a gas service provider should be provided with a reasonable opportunity to recover at least the efficient costs it incurs in providing reference services and in complying with a regulatory obligation or requirement or making a regulatory payment.
>
> Section 24(3) – a gas service provider should be provided with effective incentives to promote economic efficiency in investment in, and the operation and use of, the pipeline for the provision of pipeline services.
>
> Section 24(5) – the reference tariff charged for a reference service should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service.

There are equivalent provisions in the National Electricity Law.

As already noted, the principles and objectives mandated in the legislation recognise that customers' long-term interests are best served by providing a regulatory environment that is conducive to efficient investment. To achieve further the long term interests of customers, service providers must be provided with *a reasonable opportunity to recover at least their* *efficient costs*. Similarly, tariffs must be set to allow for a rate of return that is commensurate with the regulatory and commercial risk in providing network services.

FIG members would like to highlight two observations that arise from these objectives:

- There is no guarantee that investors will actually earn the regulated rate of return. The actual rate of return depends, quite rightly, on how well the company performs, both in terms of its costs and service levels. This important point is sometimes lost in the protracted and highly academic debates regarding cost of capital estimates.

- The cost of capital should not be set without regard to the commercial environment in which the network companies operate. Specifically, it is essential that proper regard is given to market data, and the capital markets in which funding must actually be obtained. The legislation does not direct the regulator to consider the best theoretical models. Instead, the task should be to ensure that cost of capital estimates accord with market evidence and, most importantly, to ensure the regulatory decision is consistent with promoting efficient investment.

With these observations in mind, FIG's earlier submission to the Commission's Directions Paper explained that a single cost of capital framework should apply across the gas and electricity sectors, in which:

- rate of return outcomes – rather than the methods of rate of return determination, and the parameter values used with those methods - must be subject to a market test;

- rate of return determinations are subject to adequate guidance, to provide a suitable degree of regulatory certainty and predictability; and

- merits review remains an essential element of the framework.

FIG members continue to regard these three elements as essential features of workable cost of capital provisions. Each of these key elements is examined further below:

- **Application of a market test**. A market test is consistent with the legislated objectives and principles because it would require the regulators to have regard to commercial realities, not just theoretical models and concepts.

- **Regulatory certainty and predictability**. Regulatory certainty and predictability is important because investors will only commit funds if the expected risk-adjusted rate of return is higher than alternative investment opportunities in other investment categories (including debt and equity investments in industrials, resources, financial services and other sectors) and regulated utilities in other regulatory jurisdictions around the world. A less certain and more unpredictable regulatory framework will require a higher 'headline' rate of return, all other things being equal.

- **Merits review**. Like any decision, regulatory determinations will be poorer if the decision-maker is not accountable to stakeholders. Merits review provides a robust framework for ensuring that regulators are accountable for their decisions, and that these decisions accord with all the requirements of the relevant laws and Rules. Such safeguards are critical to maintaining investor confidence in regulatory outcomes. In the absence of such safeguards, investor perceptions of regulatory risk are heightened, resulting in an increase in the expected return on capital required to attract new funds to the sector.

In relation to the overall cost of capital framework, FIG agrees with the Commission that the National Gas Rules (NGR) provides a sound basis on which to build a new rate of return framework. In particular, the less prescriptive nature of the NGR provides sufficient flexibility to consider alternative methodologies and multiple models for estimating the cost of equity. It can also allow the regulators to consider new evidence as it emerges, and to adjust or adapt their methodologies if justified.

However, while the existing NGR provisions look good in theory, the recent application of these provisions by regulators and the Australian Competition Tribunal raises serious concerns. FIG therefore shares the Commission's view that changes are required to improve the existing approach to estimating the cost of capital.

As explained in section 4 of this submission, however, FIG does not believe that the draft Rule, if implemented, would fully address the problems identified by the Commission. FIG considers that relatively modest drafting changes would better achieve the Commission's intended outcomes.

Before turning to these suggested drafting changes, the next section recaps on recent regulatory decision in relation to the cost of equity and explains why investors are so concerned.

3. Recent regulatory decisions raise significant concerns for investors

3.1 Introduction

In much the same way that the regulators should not apply CAPM in isolation from actual market data, the Commission's Rule determination should have regard to recent regulatory practice. There are three matters that FIG highlights in this section:

- Recent regulatory decisions have employed an overly mechanistic approach to the NGR provisions. The mechanical application of these provisions has produced cost of equity estimates that are unprecedentedly low, and which do not accord with capital market expectations.
- Recent decisions of the Australian Competition Tribunal have interpreted the NGR provisions in a way that encourages a relatively formulaic approach to determining the rate of return.
- The AER's submission to the Commission's Directions Paper expressed a strong preference for maintaining its current application of the CAPM. The Commission must therefore ensure that its Rules give effect to its intentions, rather than accommodating the status quo.

FIG urges the Commission to take account of these matters in finalising the cost of capital provisions. Specifically, the Rules must guard against a continuation of the current regulatory practice of applying CAPM parameters mechanistically without proper regard for the overall outcome.

Before examining these matters in further detail in sections 3.3 to 0, we wish to draw the attention of the Commission to the statements set out in 3.2 below from professional investors and fund managers, which outline the concerns of the investment community in relation to the regulators' recent cost of capital decisions.

3.2 Statements from investors

The following statements from investors reflect a number of common themes:

- Investors value consistency and predictability in regulated returns;
- Funding could readily shift away from the regulated sector to other investment opportunities, especially if perceptions of regulatory risk increase;
- Regulation should consider real-world data in setting the allowed rate of return; and
- Investors value regulatory accountability.

The first statement was prepared by Matthew Riordan and John Lake, portfolio managers at Paradice Investment Management Pty Ltd[2]:

> "Paradice Investment Management is an Australian based Fund Manager that oversees investment worth $6.9 billion. The bulk of this money is invested within Australian Equities.
>
> Within the Australian market we have a large number of companies to invest in that are exposed to many sectors and geographies. All of these companies and sectors are ultimately competing against each other for our marginal investment dollar. The Utilities sector is quite minor in the market, representing only 1.8% of our investment universe. As a house we currently hold an overweight position within the Utilities sector. This is a function of the earnings and yield certainty that these assets are expected to provide in what is a very uncertain time within the equities market.
>
> We have some concerns over the proposed draft rule changes and their potential implications for the sector. Our main concern is that there is insufficient consideration being given to the interplay between the various factors that are used in the return calculations. For example, the current low risk free rate in the form of the 10 year bond yield is a function of the heightened level of uncertainty that exists in the market at the moment which in turn should be reflected by a higher equity risk premium. There is ample evidence of this higher equity risk premium in the current subdued activity levels in the primary and secondary issuance markets. Additionally, there is also a fair argument that the Australian 10 year bond yield is being artificially subdued by high levels of foreign buying given its place in the increasingly scarce pool of AAA rated securities.

2 See http://www.pinvest.com.au/.

Regardless of the many different views that can be taken on the different factors and outcomes the key for us from an investment point of view is that there needs to be long term consistency in the allowable returns for regulated utilities. In this regard it is important to avoid a situation where investors feel that the rules can be changed on a short term basis and/or we can end up with very different outcomes for an asset based purely upon the date at which a decision is made and the market vagaries at the time. Failure to achieve this within an assets class that is perceived as defensive would certainly result in a flow of money away from the sector. With the ongoing growth of the Australian economy and population in the long term, the need for further capital to be invested into Utilities projects is a given. The private sector is going to be a key source of this capital, Stability in regulatory decisions, not volatility, is needed otherwise there is an elevated risk to us investing our clients superannuation dollars in the listed Utilities sector."

The following statement was prepared by Fidelity Worldwide Investment[3], an asset manager providing services to investors all over the world outside the US and Canada, which currently manages over US$210 billion for private individuals and institutions:

> "We acknowledge that the current regulatory approach is overly prescriptive and needs to be better linked to present market conditions. We welcome the implementation of a rate of return framework which will include a number of different models and financial analysis with a focus on market data and real-world market conditions. The framework should also define appropriate guidelines and limitations to ensure that the current regulatory accountability is maintained."

The following statement was prepared by an institutional investor with more than $130 billion of funds under management and invested on behalf of its clients, $5 billion of which is invested in utility and infrastructure assets throughout the globe:

> "As a long standing investor in regulated utilities and infrastructure assets. What attracts us and our clients to the sector is the long standing consistent application of a developed regulatory framework, the stable and appropriate level of returns provided by regulated utilities. Of course, any changes to the framework, return structure and/or appropriateness of the returns provided will increase the risk of investing in the Australian based assets and as a global investor with the competition for capital considerable we very well would need to reconsider the level of investment allocated to Australia."

The following statement was prepared by RARE Infrastructure[4], an Australian-based fund manager specialising in global infrastructure:

> "Regulators need to ensure returns are sufficient for companies to attract capital, both debt and equity, to expand networks to meet customer requirements. Global Funds like RARE have a choice whether to invest in regulated assets in Australia. Despite RARE liking the Australian regulatory framework, if allowed returns are insufficient to compensate us for the risk, we will invest our clients' capital elsewhere in the world."

---

3 See http://www.fidelity.com.au/.

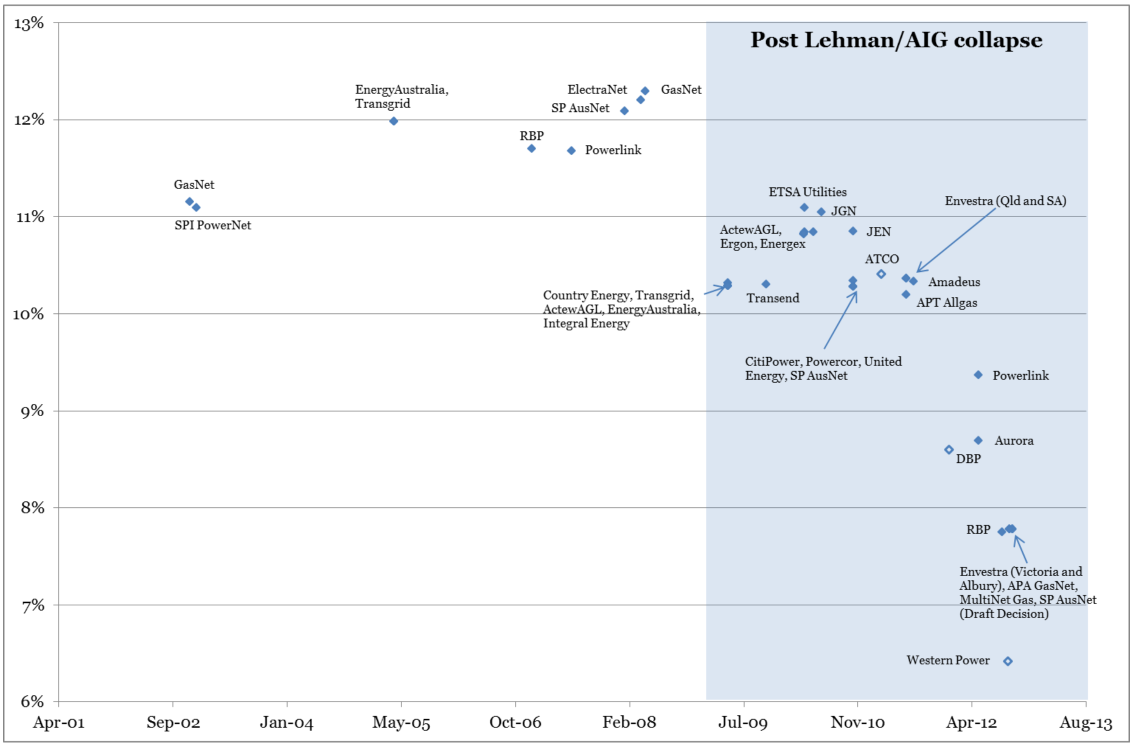
4 See http://www.rareinfrastructure.com/.

The above statements and the common themes noted earlier provide an important touchstone for the Commission as it finalises its Rules in relation to the cost of capital. In the following section, we explore in some detail the recent regulatory decisions regarding the cost of capital, which have certainly heightened investor concerns.

3.3 Recent regulatory decisions

Recent AER and ERA cost of equity decisions illustrate that both regulators have adopted an overly formulaic application of the CAPM. Figure 1, produced by CEG, shows the recent pattern of AER and ERA decisions on the cost of equity.

Figure 1: Cost of equity decisions for regulated energy businesses



The most recent regulatory determinations do not accord with the commercial reality facing investors. Since the global financial crisis, the cost of equity has not fallen 400+ basis points as suggested by the regulatory decisions set out above.

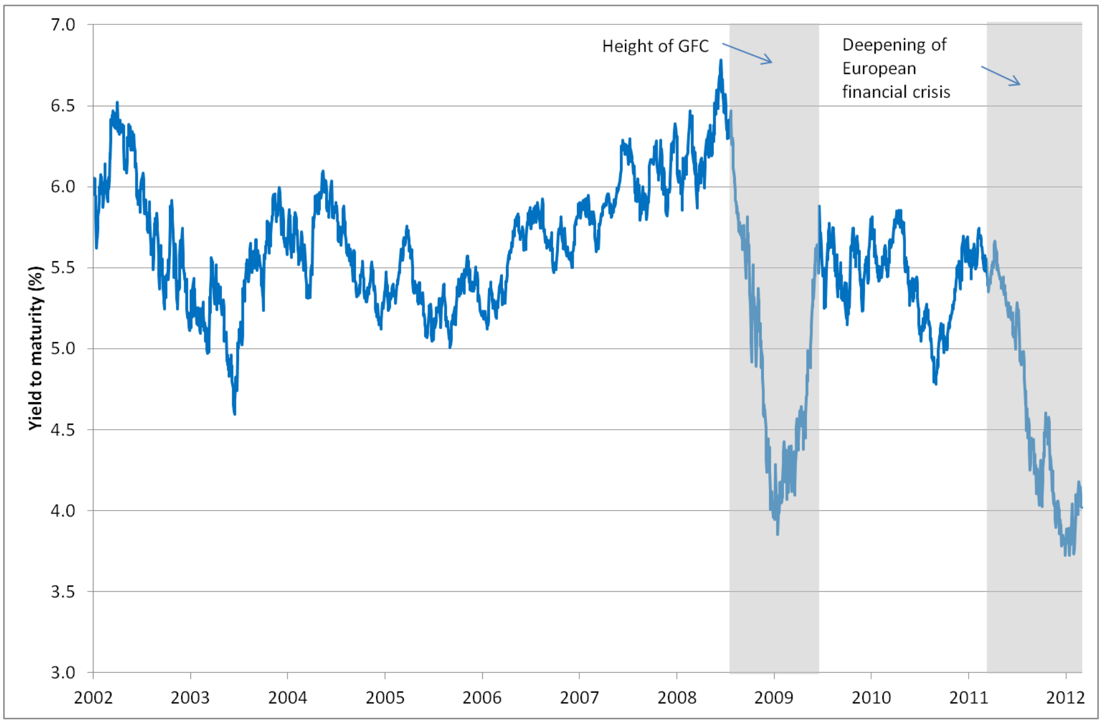
The collapse in the regulator's estimate of the cost of equity reflects a faulty perspective, which is directed to the components of the CAPM rather than the overall outcome. It provides for radically different cost of equity estimates for very similar companies, in circumstances where the 5-year regulatory periods substantially overlap.

Australian regulators have reduced the cost of equity allowance on a one-for-one basis as the yield on Government bonds has declined to their lowest level in 50 years or more. However, the decline in the yield on Government bonds does not reflect a lower risk environment. On the contrary, the low yields reflect a 'flight to quality' as domestic and international investors seek a safe haven following the global financial crisis.

In terms of the CAPM, it is reasonable to believe that the decline in the risk free rate has been offset by an increase in the Market Risk Premium (MRP), leaving the cost of equity largely unchanged. While this explanation reasonably reflects the commercial reality, it has proved impossible to persuade the regulators or the Tribunal that the MRP has increased. This outcome partly reflects genuine difficulties in measuring the MRP, but it also reflects a regulatory approach that is overly focused on the components of the CAPM.

Specifically, the reduction in the regulators' estimates of the cost of equity is due to the fall in Australian government ten year bond yields (the risk free rate) since the onset of the GFC and the deepening of the European sovereign debt crisis. The risk free rate is now at historically low levels, reflecting the 'flight to quality' described above.

Figure 2: Time series for yields on ten year Government bonds



Source: CEG, *Internal Consistency of Risk Free Rate and MRP in the CAPM*, Prepared for Envestra, SP AusNet, Multinet and APA, 30 March 2012

The regulators' mechanistic application of the CAPM - using a market risk premium derived from a long series of historic data, and a (historically low) spot measure of the risk free rate - leads it to produce cost of equity estimates that are demonstrably inconsistent with the prevailing conditions in the market for funds.

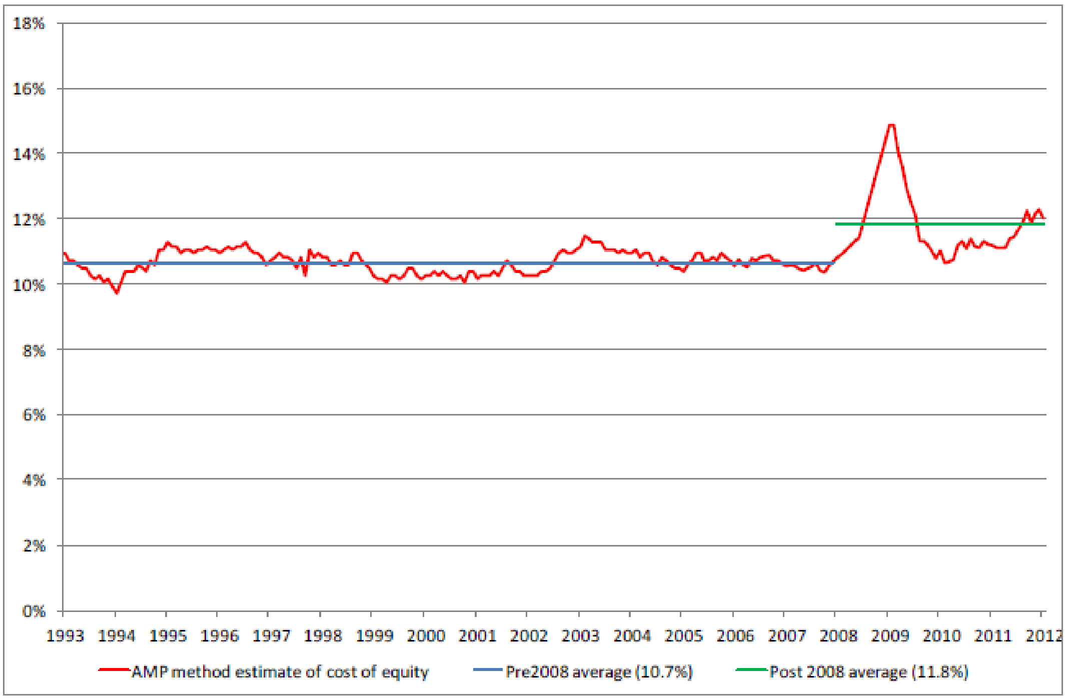
The figure below (sourced from the CEG March 2012 report) shows an estimate of the total cost of equity for the Australian market, prepared by CEG using the AMP method[5]. Figure 3 suggests that the total cost of equity has been remarkably stable between 10% and 11% since 1993. The

5 The AMP methodology involves approximating a cost of equity by adding the long term average nominal growth in GDP (as a proxy for long term average nominal growth in dividends) to the prevailing dividend yield for the market as a whole.

clear exceptions to this are the period in early 2009 and, to a lesser extent, in early 2012 when Government bonds yields were driven to unprecedentedly low levels by historical standards.

Figure 3 also shows that, using the AMP method, the average cost of equity for the market after 2008 is somewhat higher than the average prior to 2008. This is despite the average ten year Government bonds yields being materially lower in the period after 2008 (see Figure 2 above).

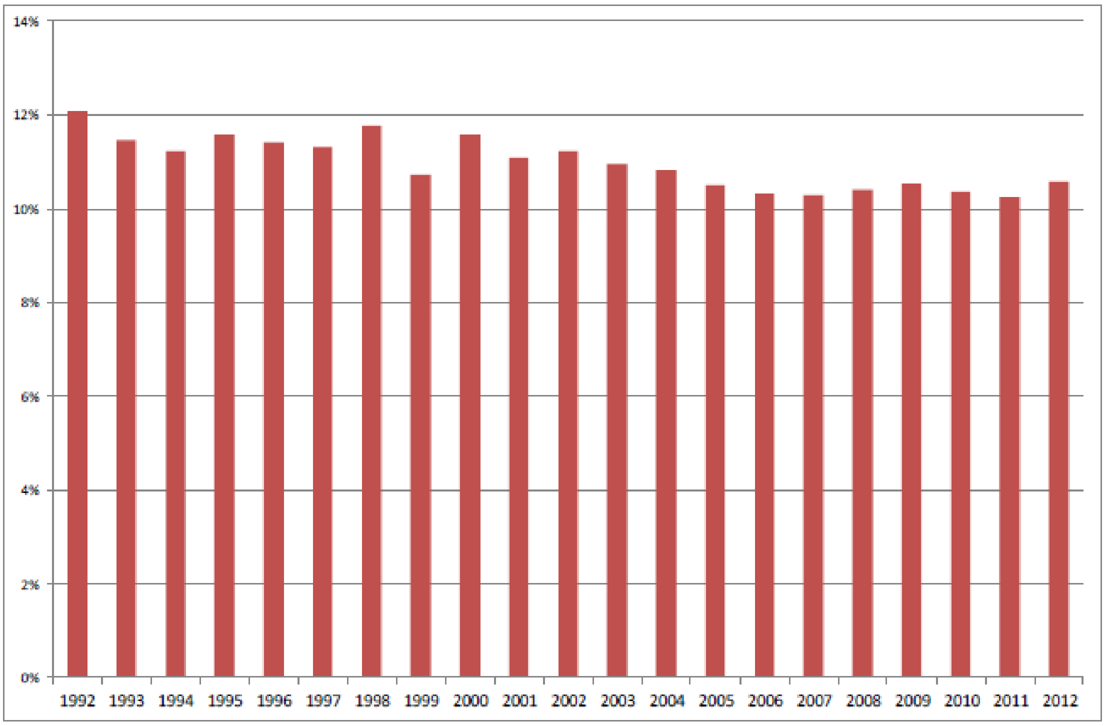
Figure 3: Total cost of equity (AMP method)



Source: RBA, CEG analysis

A similar pattern of stability in the return on equity is evident in the return on equity allowances for regulated US energy firms averaged across all regulatory decisions, shown in Figure 4 below.

Figure 4: US regulatory return on equity decisions over 20 years – average per year



Source: SNL Financial Business Intelligence Services, CEG analysis

This stability in the expected return on equity is consistent with intuition and the experience of capital market practitioners:

- The cost of equity is not simply a function of the risk free rate. It depends on what expected returns are in other equity sectors and in other capital markets.

- The expected return on equity is less volatile than the risk free rate because equity investment horizons are generally longer than debt investment horizons, meaning equity capital is generally 'stickier' and generally, equity investors expect returns to revert to long term average levels as the cycle progresses.

- The CAPM does not reflect investor behaviour in that investors disproportionately weight the risk of losing all their equity capital, so the predictive power of CAPM is poor when the risk free rate is low. This implies that there is a floor on expected equity returns.

Stability in regulators' estimates of the cost of equity is also observable in the decisions of UK regulators, who take a more pragmatic approach to this important task. As explained in further detail below, these regulators have given more weight to the overall outcome in terms of the cost of equity by recognising its relative stability, rather than focusing on the less stable components of the CAPM. In this way, the UK regulators are more in tune with the approach adopted by market practitioners as opposed to academics.

Ofgem, the UK energy regulator, has maintained a consistent approach to estimating the cost of capital based on advice commissioned by a consortium of UK regulators. This advice is provided in two reports from Smithers & Co in 2003[6] and 2006.

In its 2003 report, Smithers & Co highlighted analysis in relation to US data[7], which supports the proposition that cost of equity is relatively stable over time. Importantly, the Smithers reports explain that there is far less evidence of stability in relation to the market risk premium and the risk free rate.

The implications for how regulators should approach the task of estimating the cost of equity is unequivocal, according to Smithers & Co. In their view, it would be a mistake to focus on estimating the relatively unstable market risk premium and the risk free rate. Instead, regulators should focus on estimating the more stable cost of equity directly.

The implication of the UK experience is clear for Australian regulators. Evidence from the UK illustrates the problems that arise from assuming that the MRP is constant – when it is not – and then combining this constant estimate of the MRP with a risk free rate which the historic data shows to be unstable. In colloquial language, the Australian approach takes a 'roulette wheel' approach to the cost of equity, by assuming that the expected return on equity moves on a one-for-one basis with an unstable risk free rate. This is sharply at odds with the UK regulatory approach to estimating the cost of equity.

It must also be noted that Ofgem is not alone in following the advice of Smithers & Co. In a 2010 appeal of a regulatory decision brought by Bristol Water, the UK appeal body (the Competition Commission) recognised that the yield on government bonds may be artificially depressed. The Competition Commission concluded that the appropriate estimate of the risk free rate should be based on a longer-term view.

Ofcom – the UK communications regulator – is the only UK regulator to have set prices in the past two years, so its judgement on the current value of risk free rate is particularly relevant. In the 2011 Mobile Termination case Ofcom explicitly recognises the problems caused by quantitative easing, and argues that more weight should be placed on long run averages. Ofcom uplifted the then current estimates of the risk free (which were zero or negative) to 1.5%, citing long run averages and the precedent set by the Competition Commission in the Bristol Water appeal.

This is precisely the lesson that should be adopted by the Australian regulators, but there is a resistance to such pragmatism.

FIG notes that the Smithers reports provide a very comprehensive analysis of the available data and the academic literature. They are reports that are widely accepted by UK regulators. Of course, there remain many unresolved issues in relation to the cost of capital, but the advice to UK regulators from the Smithers reports is unequivocal. According to Smithers & Co regulators should be focused on the cost of equity rather than its component parts. The Smithers reports emphasise that attempts to estimate the cost of equity by focusing on the MRP and risk free rates may lead to error. This is precisely the recent experience in Australia.

6 A Study into Certain Aspects of the Cost of Capital for Regulated Utilities in the U.K., 13 February 2003.
7 Professor Jeremy J Siegel, Stocks for the Long Run, McGraw-Hill, second edition, 1998.

Our experience as investors is that the cost of equity has not fallen since 2008 by 400 basis points, as the Australian regulators' recent decision suggest. There is a credibility gap between what is known in the market place and recent regulatory decisions. The gap is explained by regulatory error, and the Commission is right in expressing the view that a mechanical application of any particular theory can lead to error.

3.4 Concerns regarding interpretation of the existing Gas Rules

As already noted, FIG agrees with the Commission that the NGR provide a sound basis on which to build a new rate of return framework. Specifically, the less prescriptive nature of the NGR provides sufficient flexibility to enable the consideration of alternative methodologies and multiple models for estimating the cost of equity.

As the Commission is aware, two recent decisions of the Australian Competition Tribunal have set out the Tribunal's interpretation of rules 87(1) and 87(2) of the NGR. In relation to these decisions, the Commission states[8]:

> "In both the ATCO Gas and DBNGP cases, the Tribunal rejected the contention of the applicants that giving primary emphasis to rule 87(1) would reflect the NGO and the RPP. Such a conclusion does not reflect the policy intention of the Commission. The Commission's policy intention is for the primary consideration to be whether or not the overall allowed rate of return reflects benchmark efficient financing costs. A focus on the overall estimate of the rate of return is a key policy objective for the new framework."
>
> "A focus on the overall estimate of the rate of return is a key objective of the new rate of return framework. It is the Commission's belief that requiring the regulator to have regard to more relevant information on estimation methods, financial models and other market data and allowing the regulator more capacity to achieve the overall objective, combined with a strengthened emphasis on achieving this objective, is more likely to achieve the NEO and the NGO than the current approaches."

FIG welcomes, and concurs with the views expressed by the Commission. We share the concern expressed by the Commission that rules 87(1) and (2) as interpreted by the Tribunal, could be applied in such a way as to reduce the range of information that can be used in estimating the rate of return. The Tribunal's interpretation will further encourage formulaic approaches to determining the rate of return, rather than focussing on whether the overall estimate of the rate of return is consistent with market evidence. As explained in further detail in section 4 of this submission, it is important that the drafting of the Commission's Rule determination gives full effect to the policy intention of the Commission.

---

8 AEMC, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Draft Rule Determinations, 23 August 2012, pages 54-55.

3.5 Regulators prefer a formulaic approach to the cost of equity

As already noted, FIG strongly agrees with the Commission that:

> "[ ] estimates are more robust and reliable if they are based on a range of estimation methods, financial models, market data and other evidence. A framework that eliminates any relevant evidence from consideration is unlikely to produce robust and reliable estimates, and consequently is unlikely to best meet the NEO, the NGO and the RPP."

In contrast to the Commission's conclusions, however, the AER has argued strongly in favour of its continued use of the CAPM[9]:

> "The AER does not agree with the AEMC, or SFG. In general, finance theory and methods are slow to develop. Indeed, none of the alternative financial models proposed by gas NSPs— Fama French three factor model (1993), Black CAPM (1972), Merton's inter-temporal CAPM (1973) and dividend yield models (1959)—represent recent theoretical developments. The likelihood, therefore, of one model suddenly becoming a definitively better model than the alternatives is low. That is, the AER has already considered whether alternative models can consistently produce better estimates of the required return on equity than the CAPM. Similarly, the AER has already considered the limitations of the CAPM, as noted by CEG."

The AER continued that if the Commission did not accept its position, in the alternative, the AER proposed that[10]:

> "The Gas Rules be amended such that the use of a specific cost of equity model is to be determined in the WACC review and that the outcome from the WACC review must be subsequently applied in each applicable access arrangement. This contrasts with the current Gas Rules where the choice of model is determined in each access arrangement."

It is evident from the AER's submissions that it believes that a single model is superior to a multiple model approach. Furthermore, the submission is focused on models rather than market evidence.

The ERA has not lodged a submission on these matters, but its conduct in recent decisions[11] also reflects its preference for applying a formulaic approach.

In contrast to the AER's position, the submission from the energy policy body in Western Australia (the Public Utilities Office) recognised the potential difficulties that may arise in codifying the CAPM[12]. These views accord more with the Commission's views, which FIG supports:

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9 AER, AEMC Directions Paper Economic Regulation of Network Service Providers, submission, April 2012, page 43.

10 Ibid, page 43.

11 See, for instance, the ERA's Final Decision on Proposed Revisions to the Access Arrangement for the Western Power Network, 5 September 2012.

12 Michael Kerr, Acting Deputy Director General, Public Utilities Office, 19 April 2012, page 4.

> "The Office holds a strong view that there would be no benefit from amending the NGR in relation to the Capital Asset Pricing Model (CAPM) as proposed by the AER. The Office is of the view that the NGR works well in its current form and that codification of the CAPM model is restrictive and could potentially result in further amendments in the future should the CAPM model fall out of favour as the preferred model to calculate the cost of equity."

It is evident from the conduct of the ERA and the views expressed by the AER and the Public Utilities Office in Western Australia that regulatory and policy bodies currently hold widely differing views on how best to estimate the cost of capital. In this context, the Commission as Rule-maker should clarify the approach that should be taken.

As a practical matter, given the AER's stated preference for maintaining the status quo, the draft Rules should ensure that the Commission's intentions are given effect. As already noted, FIG applauds the Commission's intentions but, as the next section explains, there is concern that the draft Rules would allow the status quo to continue.

4. Commentary on the Draft Rules

4.1 Introduction

This section provides high-level feedback on the draft Rules in relation to the cost of capital.

By way of background the draft Rules set out the following provisions in relation to the rate of return, the cost of equity and the cost of debt. The following clauses refer to electricity distributors, but the Commission also proposes equivalent provisions for the other energy networks.

Clause 6.5.2(b) sets out the allowed rate of return objective as follows:

> "The allowed rate of return for a Distribution Network Service Provider must correspond to the efficient financing costs of a benchmark efficient entity with a similar nature and degree of risk as that which applies to the Distribution Network Service Provider in respect of the provision of standard control services."

In relation to the return on equity, clause 6.5.2(e) requires that:

> "The return on equity for a regulatory control period must be estimated:
>
> (1) in a way that is consistent with the allowed rate of return objective; and
>
> (2) taking into account the prevailing conditions in the market for equity funds."

In relation to the cost of debt, clause 6.5.2(f) requires that:

> "The return on debt for a *regulatory year* must be estimated:
>
> (1) in a way that is consistent with the *allowed rate of return objective*; and
>
> (2) using a methodology under which:
>
> (i) the return on debt for each *regulatory year* in the *regulatory control period* is the same; or;

(ii) the return on debt for a *regulatory year* (other than the first *regulatory year* in the *regulatory control period*) is estimated using a methodology which complies with paragraph (i).

The cost of debt methodology referred to above is defined as follow in clause 6.5.2(i):

> "A methodology referred to in paragraph (f)(2)(ii) must provide for any change in the *Distribution Network Service Provider's annual revenue requirement* for the *regulatory year* that would result from a change to the *allowed rate of return* for that *regulatory year*, as a result of the return on debt for that *regulatory year* being different from that estimated under subparagraph (f), to be effected through the automatic application of a formula that is specified in the distribution determination."

There are four matters that FIG would like to comment on in relation to these provisions:

- Rate of the return methodologies;
- Rate of return objective and the cost of equity;
- Cost of debt provisions; and
- WACC guidelines.

Our comments on these matters are set in the sections below. A consistent theme in each of these sections is that the current drafting allows for widely differing interpretations and approaches. While FIG acknowledges that flexibility is desirable, the unintended consequence of imprecise drafting is that the Commission's policy intentions may be unrealised and, in particular, a narrow formulaic application of a single model, such as the CAPM, would be accommodated.

4.2 Rate of Return Methodologies

Key points

- The Rules must give effect to the Commission's policy intent that the estimate of the return on equity should not be formulaic and should not be driven by a single model or estimation method.

- The current drafting does not give effect to this intent. Under the current drafting the regulators would be at liberty to continue to apply their current approach, which is overly formulaic.

- The current drafting should be revised to clarify that the allowed rate of return is not to be based solely on the output of an estimation method or financial model, but instead based on a combination of relevant estimation methods, financial models, market data and other evidence. This will ensure that the policy intent of the Commission is achieved.

Discussion

The Commission intends that the estimate of the return on equity should not be formulaic and should not be driven by a single financial model or estimation method. The Commission is of the view that estimates are more robust and reliable if they are based on a range of estimation methods, financial models, market data and other evidence. As already noted, FIG supports the Commission's policy position.

However, the current form of drafting, outlined in section 4.1 above, could be construed to allow the AER to consider a range of methodologies and approaches and, having conducted that consideration, to prefer one methodology over the others and then apply that single preferred methodology. Such a construction would be inconsistent with the Commission's intention that the regulator apply a range of methodologies and weight those methodologies in exercising its discretion.

Outline of proposed drafting changes

The Attachment sets out FIG's proposed revisions to the Commission's draft Rule.

FIG proposes that the cost of equity must be based on a combination of relevant estimation methods, financial models, market data and other evidence.

In addition, FIG recommends that the drafting includes a requirement that the cost of equity must not:

- be estimated using only the Sharpe-Lintner Capital Asset Pricing Model; and
- be determined solely on the output of a single estimation method or financial model.

4.3 Rate of return objective and the cost of equity

Key points

- The drafting provisions for the rate of return objective do not make any mention of competitive markets or market data.
- The Commission's proposed drafting gives a lower priority to 'the prevailing market conditions' than the current Rules.
- FIG is therefore concerned that, as presently drafted, the Rule will not promote the NEO or NGO, which is rightly focused on promoting efficient investment.

Discussion

FIG notes that the rate of return objective refers to the efficient financing costs of a benchmark efficient entity with a similar nature and degree of risk as the regulated company. The Commission is right to focus on efficiency and benchmarking because these concepts are important features of incentive based regulation.

The benchmarking concept also captures an important goal that should guide all regulatory decisions – regulation should not affect the investment and financing decisions that a company would make in the absence of regulation. In other words, regulation should not affect the efficient investment and financing decisions that would be made in a competitive market. It would be helpful, therefore, if the reference to "benchmark efficient entity" in the rate of return objective clarified that the benchmark should refer to competitive markets. It would also be helpful if the objective did not refer to entities of a 'similar nature to the service provider' when defining the benchmark efficient entity because those words might be interpreted as confining the scope of the benchmark to regulated network service providers.

In addition, the cost of equity provisions must also recognise the importance of prevailing conditions in the market. At present, the drafting relegates this information to a factor that the AER must 'take into account'. As funding must be raised in capital markets, market information must be given the highest weighting by the regulator. The current drafting does not achieve that outcome, and therefore encourages an estimate of the cost of equity that is grounded in theory rather than practice.

Outline of proposed drafting changes

The Attachment sets out FIG's proposed revisions to the Commission's draft Rule.

In the rate of return objective, FIG recommends that 'efficient entity' should be defined with reference to a benchmark in a competitive market. As presently drafted, the benchmark could refer to the network service provider's own financing costs, which would be contrary to the principles of incentive regulation.

In addition, FIG notes the Commission's views that achieving the best possible estimate of the benchmark efficient financing costs is desirable and agrees with that view in circumstances where the regulator is given the very wide discretion that is proposed in the draft Rule. The natural corollary of a wide discretion is specific guidance in its exercise. Accordingly FIG recommends the language of 'best estimate' be employed. On the other hand, if the discretion is to be limited, less specificity is required. If the regulator is to not to enjoy the proposed width of discretion but is to be limited to some degree, the current language of the NGR of the allowed rate of return being 'commensurate' with the benchmark would be appropriate.

In relation to the cost of equity provisions, FIG proposes that the Rules should require the estimated cost of equity to be commensurate with the prevailing condition in the market for funds. This amendment will ensure that the estimated cost of equity takes proper account of the available market evidence and data.

The draft provisions also clarify that the test of 'prevailing conditions in the market for funds' is to be applied to the overall estimate of the cost of equity allowance, and not to the individual parameters that are input to models such as the CAPM. In the absence of this amendment, the draft Rule will be inconsistent with the NEO and NGO, which are rightly focused on promoting efficient investment for the long term benefit of consumers.

4.4 Cost of debt

Key points

- FIG accepts the Commission's view that a range of approaches should be adopted in estimating the cost of debt. This may include a trailing average approach.

- It is essential that the draft Rule makes it clear that the allowance for the cost of debt is a benchmark.

- The current drafting could be interpreted as allowing the regulator to provide network service providers with their actual cost of debt. This would be contrary to the principles of incentive regulation.

Discussion

FIG strongly supports the Commission's approach to the cost of debt in two respects:

- Regulators should consider a range of approaches to estimating the return on debt, including approaches that average estimates of the return on debt over historical periods.

- The methodology used to estimate the return on debt should reflect, to the extent possible, the efficient financing and risk management practices that might be expected in the absence of regulation.

Importantly, however, the Commission must preserve the regulatory principle that the cost of debt should be an efficient benchmark. The Commission appears to recognise this point in the following comments from its draft determination:

> "A historical trailing average approach still requires the regulator to define a benchmark and use appropriate data sources to measure it. Arguably, it is even more important that the benchmark is defined very clearly and can be measured, because it needs to be estimated periodically in the future. The measurability of the approach would be a factor that the regulator would have to consider as part of its assessment of different approaches."

In light of the Commission's intentions outlined above, FIG considers that the Rules should make it much clearer that the requirement is to set a benchmark cost of debt for an efficient firm.

Presently, a number of provisions could be misinterpreted as suggesting that the cost of debt allowance should be adjusted to reflect the network service provider's actual costs of debt. This interpretation is contrary to many years of well-accepted regulatory practice, and would be inconsistent with the NEO and NGO, which are concerned with efficient outcomes.

In relation to the Commission's suggestion that the benchmark allowance for the cost of debt could be based on a trailing average, FIG notes the extensive work undertaken by the Commission, including the study by SFG Consulting. Evidently, there are numerous issues that would need to be worked through before FIG could accept a trailing average approach. Nonetheless, FIG accepts that it is appropriate for the Rules to include provisions that enable the use of a trailing average, among other alternative approaches, to determine the cost of debt allowance.

FIG considers that Rules should provide that the decision to adopt a trailing average approach is to be made by the Service Provider. This proposal recognises that:

- Network service providers may have debt portfolios that make a trailing average approach untenable;
- The Rules should be sufficiently flexible to accommodate different approaches across companies, rather than adopting a one-size fits-all approach; and
- Each network service provider, rather than the AER, is best placed to determine whether the trailing average approach is a feasible methodology given its particular circumstances.

Outline of proposed drafting changes

The Attachment sets out FIG's proposed revisions to the Commission's draft Rule.

FIG has clarified that the 'return on debt' is a 'benchmark allowance for the cost of debt'. This change will address FIG's concern that the current drafting is at risk of straying from the well-accepted principle that the cost of debt should be a benchmark allowance.

In addition, FIG has suggested the removal of clauses that provide no further guidance to the regulators beyond that already provided by the rate of return objective or the NEO/NGL. FIG's suggested approach simplifies the drafting and also minimises the potential for inappropriate interpretations to be applied at a later date.

The remaining drafting changes are intended to remove potential ambiguities that arise in the current drafting, and to give effect to arrangements that enable the Service Provider to elect the method to be applied in determining the cost of debt allowance. As already noted, FIG supports the Commission's policy intent in relation to the cost of debt, and therefore the proposed changes are intended to give effect to that intent.

4.5 WACC Guidelines

Key points

FIG supports the concept of WACC guidelines, provided that:

- they are subject to effective and meaningful consultation with stakeholders; and
- they provide reasonable certainty and predictability regarding the approach that the regulators will adopt in determining the cost of capital.

Discussion

In FIG's view, the proposed Rule does not require the guidelines to set out sufficient detail of the information that the regulator would expect to have regard to, and why it has chosen to have regard to that information and not other information. It does not require the guidelines to incorporate best practice in the application of the financial models and market data. If it is the Commission's intention that the guidelines meet these standards, that intention should be drafted into the Rules.

As presently drafted, the guidelines would be non-binding and not subject to merits review. It follows that meaningful consultation and the future application of the guidelines will depend solely on the actions of the regulators concerned. In effect, the regulator will not be held to account if the guidelines are unreasonable or inappropriate, nor if the regulator strays from the guidelines without good cause. The absence of effective accountability is detrimental to the achievement of the NEO and NGO.

FIG appreciates that a careful balance must be struck between mandating a fixed approach – which may prove to be inappropriate if circumstances change – and allowing a regulator to 'make it up as it goes along' – which will not produce the stable regulatory environment that is a pre-requisite for promoting efficient investment.

As currently drafted, the provisions governing the WACC guidelines will only prove effective if the regulators show self-restraint. Experience shows that formal accountability will ultimately outperform self-restraint. FIG therefore urges the Commission to re-examine the provisions carefully, in light of the changes we have suggested, to ensure that the WACC guidelines genuinely inform and guide the regulator's approach, and are developed following effective consultation with stakeholders.

Outline of proposed drafting changes

The Attachment sets out FIG's proposed revisions to the Commission's draft Rule.

FIG proposes the incorporation of provisions into the Rule that would require the guidelines to be consistent with the requirements in relation to the estimation of the cost of equity and benchmark debt allowance. In particular, the guidelines must be consistent with the requirement that the cost of equity should not be determined solely by reference to a single model, such as the CAPM.

The Rules would also require regulators to comply with a defined rate of return consultative procedure in developing WACC guidelines. In addition, regulators would be required to fully explain their approach to estimating WACC in the guidelines, including matters such as:

- the estimation methods, financial models, market data and other evidence on which the regulator will base its WACC estimate;
- the reason for its choice of those estimation methods, financial models, market data and other evidence; and
- how the regulator proposes to deal with new information or evidence that is relevant to estimating WACC.

5. Concluding comments

FIG substantially agrees with the Commission's views in relation to the cost of capital. However, FIG is concerned that the regulators' recent decisions and their preference for a formulaic approach can continue to be accommodated under the draft Rule, contrary to the Commission's intent. The drafting of the provisions should therefore be improved to ensure that the Commission's intentions are given effect, and to minimise the scope for misinterpretation.

FIG considers it appropriate for the Rules to provide more guidance to the regulators in estimating the cost of capital. In particular, the Rules should provide specific guidance to the regulators to ensure that market evidence is fully and properly considered when cost of capital decisions are made.

The suggested drafting changes provided in the attachment address the concerns raised by FIG and are consistent with the NEO and NGO.

Attachment: Mark-up showing suggested changes to draft Rule

Rule 87 Rate of return

(1) The return on the projected capital base for each regulatory year of the *access arrangement period* is to be calculated by applying a rate of return that is determined in accordance with this rule 87 (the *allowed rate of return*).

(2) The *allowed rate of return* is to be the best estimate of the cost of capital that corresponds to the efficient financing costs of a benchmark efficient entity in a workably competitive market, assuming a similar degree of risk as that which applies to the service provider in respect of the provision of reference services (the *allowed rate of return objective*).

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(3) The *allowed rate of return* for a regulatory year is to be determined:

(a) as a weighted average of the benchmark allowance for the cost of equity for the *access arrangement period* (as estimated under subrule (5)) and the benchmark allowance for the cost of debt for that regulatory year (as estimated under subrule (6)) where the weights applied to compute the average reflect the relative proportions of equity and debt finance that would be employed by a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of reference services;

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(b) on a nominal post-tax basis that is consistent with the estimate of the value of imputation credits referred to in rule 87A; and

(c) based on relevant estimation methods, financial models, market data and other evidence.

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(4) In determining the *allowed rate of return*, regard is to be had to:

(a) a presumption in favour of consistent application of any estimates of financial parameters that are relevant to the estimates of, and that are common to, the benchmark allowance for the cost of equity and the benchmark allowance for the cost of debt; and

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(b) any interrelationships between estimates of financial parameters that are relevant to the estimates of the benchmark allowance for the cost of equity and the benchmark allowance for the cost of debt.

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Benchmark allowance for the cost of equity

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(5) The benchmark allowance for the cost of equity for an *access arrangement period* is to be estimated:

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(a) to achieve the *allowed rate of return objective*; and

(b) to be commensurate with prevailing conditions in the market for equity funds.

(5A) The benchmark allowance for cost of equity for an access *arrangement period* is:

(a) not to be estimated using only the Sharpe-Lintner Capital Asset Pricing Model; and

(b) not to be based solely on the output of a single estimation method or financial model, but instead based on a combination of relevant estimation methods, financial models, market data and other evidence.

(5B) The estimation methods and financial models must use input parameters that result in an estimate of the benchmark allowance for the cost of equity that is commensurate with prevailing conditions in the market for equity funds, however those parameters need not necessarily be commensurate with prevailing conditions in the relevant market.

Benchmark allowance for the cost of debt

(6) The benchmark allowance for the cost of debt for a regulatory year:

(a) is to be estimated to achieve the *allowed rate of return objective*;

(b) is to be estimated using a methodology under which:

(i) the benchmark allowance for the cost of debt for each regulatory year in the access arrangement period is the same; or

(ii) if the methodology used results in an estimate referred to in sub-rule (7)(b), the benchmark allowance for the cost of debt is updated each regulatory year in the access arrangement period; and

(iii) if the methodology referred to in sub-rule (b)(i) is used (resulting in an estimate referred to in sub-rule (7)(a)), is to be estimated to be commensurate with the prevailing conditions in the market for debt funds.

(7) The methodology adopted must result in an estimate of:

(a) the return that would be required by debt investors in a benchmark efficient entity if it raised debt at the time or shortly before the time when the AER's decision on the access arrangement for that access arrangement period is made;

(b) the average return that would have been required by debt investors in a benchmark efficient entity if it raised debt over

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Deleted: 7) Subject to subrule (6),

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Deleted: the return on debt reflecting a period prior to the time when the AER's decision on the access arrangement for that access arrangement period is made; or

(c) some combination of the returns referred to in subparagraphs (a) and (b).

(7A) The AER's discretion under sub-rules (6) and (7) is limited.

[Note: A corresponding amendment is to be made to rule 72(1) for the service provider to propose the methodology to be used to estimate the benchmark allowance for the cost of debt. It is intended that under rule 7A, the AER must accept the service provider's proposed methodology if the proposal satisfies the NGO and the *allowed rate of return objective*.]

(8) A methodology referred to in subrule (6)(b)(ii) must provide for any change in total revenue for the regulatory year arising from that methodology to be effected through the automatic application of a formula that is specified in the access arrangement.

Rate of return guidelines

(9) The AER must make guidelines (the *rate of return guidelines*), in accordance with the *rate of return consultative* procedure except that the first *rate of return guidelines* are to be made in accordance with subrule (13).

(10) The *rate of return guidelines* are to set out how the AER proposes to exercise its discretion under this Rule, including without limitation:

(a) the methodologies that the AER proposes to use in estimating the *allowed rate of return,* including how those methodologies are proposed to result in the determination of a benchmark allowance for the cost of equity and a benchmark allowance for the cost of debt to achieve the *allowed rate of return objective*;

(b) the estimation methods, financial models, market data and other evidence on which the AER will in combination base its estimate of the rate of return

(c) how the AER proposes to meet the requirement of sub-rule (5A), including:

(i) why it has chosen the estimation methods, financial models, market data and other evidence on which it will in combination base its estimate of the rate of return in preference to others;

(ii) the proposed relative weighting of the estimation methods, financial models, market data and other evidence it has chosen.

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(8) In determining whether the return on debt for a regulatory year is estimated in a way that is consistent with the allowed rate of return objective, regard must be had to the following factors:¶
¶
(a) . the likelihood of any significant differences between the costs of servicing debt of a benchmark efficient entity

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¶
(c) . the incentive effects of inefficiently delaying or bringing forward capital expenditure; and¶
(d) the impact of changing the methodology for estimating the return on debt across access arrangement periods.¶
¶
(9) . A methodology referred to in subrule (6)(2

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Deleted: , make guidelines (the *rate of return guidelines*),

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(iii) what market data (or similar) the AER proposes to use to ascertain lower bounds and reasonableness checks on the estimates;

(iv) current estimates of financial parameters that are relevant to the estimates of the benchmark allowance for the cost of equity and a benchmark allowance for the cost of debt;

(d) other information the AER proposes to have regard to and why it proposes to do so rather than other information;

(e) how the AER proposes to deal with new information or evidence at the time when the AER's decision on the access arrangement for that access arrangement period is made.

(11) The AER must make the first *rate of return guidelines* by [29 August 2013] and there must be *rate of return guidelines* in force at all times after that date.

(12) For the purposes of making the first *rate of return guidelines* the AER must:

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(a) by no later than [29 March 2013], publish on its website a consultation paper that sets out its preliminary views on the material issues that are to be addressed by the *rate of return guidelines* and how it intends to address those issues;

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(b) publish on its website an invitation for written submissions on the consultation paper, with such submissions to be made within the time specified in the invitation (which must not be earlier than 30 business days after the invitation for submissions is published);

(c) by no later than [31 July 2013], publish on its website a draft of the *rate of return guidelines* with reasons; and

(d) publish on its website an invitation for written submissions on the draft rate of return guidelines, with such submissions to be made within the time specified in the invitation (which must not be earlier than 30 business days after the invitation for submissions is published).

(e) publish on its website the *rate of return guidelines* with reasons.

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(13) The AER must, in accordance with the rate of return consultative procedure, review the *rate of return guidelines*:

(a) at intervals not exceeding three years, with the first interval starting from the date referred to in subrule (12); and

(b) at the same time as it reviews the *rate of return guidelines* under clauses 6.5.2 and 6A.6.2 of the National Electricity Rules.

(14) The AER may, from time to time and in accordance with the *rate of return consultative procedure*, amend or replace the *rate of return guidelines*.

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(15) The *rate of return guidelines* are not mandatory (and so do not bind the AER or anyone else) but, if the AER makes a *decision* in relation to the rate of return (including in an access arrangement draft *decision* or an access arrangement final *decision*) that is not in accordance with them, the AER must state, in its reasons for the *decision*, the reasons for departing from the guidelines.

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