A Consumers' Snapshot of the Rate of Return

Purpose

This Snapshot is intended to provide a very high-level overview of what the rate of return is, how it is calculated and why it is important in the context of delivering energy network services to consumers.

What is the Rate of Return?

The rate of return is an estimate of what it costs a business to get the funds it requires to invest in the business.

The Australian Energy Regulator's (AER's) Rate of Return Guideline sets out how it will determine the return that all regulated energy network businesses in Australia can earn on their investments. This is done by using a method called a Weighted Average Cost of Capital (WACC). It is a very common financial term and method that has been used by the AER for many years. This method is also used by many other businesses and industries in Australia and around the world.

How to estimate the Rate of Return?

The rate or return (or WACC) is an estimate of the cost of funds the business requires to attract investment. To estimate this cost, we consider the cost of the two sources of funding for investments – equity and debt. The cost or return that investors expect on their investments is known as the return on equity.

The cost or interest rate that a business pays to borrow money to invest is known as the return on debt. A combination of these two returns, weighted by an estimate of the proportion of equity and debt used by the business, will give us the WACC.

At a very high-level, the AER calculates the WACC as:

WACC	=	Return on Equity x 40%	+	Return on Debt x 60%

Why does the Rate of Return Matter?

Energy network businesses provide infrastructure that is crucial to enabling the Australian economy and to support our modern lifestyles. Energy network businesses are capital-intensive, which means they build, operate and maintain assets like electricity substations, poles and wires and gas pipelines. These assets typically have a long life, with some assets spanning over 40 years.

To ensure that we can deliver our services in a safe and reliable way to meet the needs of our customers, energy network businesses must be able invest in their networks when they need to. Some of the key drivers for network investment are to:

» replace ageing infrastructure, for example, many networks were developed in the 1950s to 1970s;

» meet system security and reliability requirements, including as a result of the changing generation mix toward renewables; and

» meet or manage customer demand, including for connection to the grid.

The returns earned by regulated energy businesses on their capital investments are a large part of the annual revenues the regulator allows them to collect. In the end, these revenues impact the final charges paid by consumers.

The AER's approach to how to determine the rate of return will impact a business' ability to attract investment funds and the commercial sustainability of its business.

More Information?

To help consumers get a more detailed understanding of the rate of return, its key inputs and the current key issues around this, Energy Networks Australia intends to publish a Consumers' Guide to the Rate of Return in due course. If you would like more information on this Snapshot or Energy Networks Australia's approach to AER's Rate of Return Guideline Review, please contact **Garth Crawford on 02 6272 1555**.