Energy Networks Australia Submission on AER Issues Paper for the Rate of Return Guideline Review

AER's Rate of Return Guideline Review

The Australian Energy Regulator (AER) is reviewing its current 2013 Rate of Return Guideline (Guideline). The Guideline clarifies the AER's approach to setting the regulated rate of return for electricity and gas networks. It sets out how the regulator will determine the efficient financing costs of network businesses for the purpose of setting future revenues and prices.

Why the Rate of Return Matters

The Rate of Return Guideline is a key factor in setting the largest single component of annual regulated revenues (approximately 60-70%) received by electricity and gas networks, and it affects nearly every Australian energy consumer.

The Rate of Return impacts directly how electricity and gas networks invest to support safe, reliable and efficient delivery of energy services, which are regulated by the AER to further the national energy objectives. A good estimate of the Rate of Return ensures there are efficient levels of investment and that customers pay no more than is necessary for a safe, reliable and secure energy supply.

Estimating the required Rate of Return is complex. Establishing a predictable, transparent and evidence-based Rate of Return Guideline is critical for Australia's energy future because it allows for the efficient financing of long-lived infrastructure and other energy solutions to meet the needs of almost 10 million Australian electricity customers and around 5 million gas customers.

Energy Networks Australia's Role

Energy Networks Australia understands energy prices are a concern to consumers and that the Guideline needs to deliver outcomes in the long-term interests of consumers.

Ensuring network businesses are able to achieve a reasonable, predictable and sustainable return on investment makes it possible for networks to make long-term investments in essential infrastructure that supports Australia's energy needs. We have committed to engaging with consumer groups, stakeholders and the AER during the AER's Rate of Return Guideline Review.

Energy Networks Australia is committed to ensuring that the allowed rate of return provides for an outcome that is in the long-term interests of consumers. Our aim is to develop an industry position on the Rate of Return that is capable of acceptance by all stakeholders.

Engagement

The purpose of our engagement is to seek the views of consumers and other stakeholders, to help inform Energy Networks Australia's own positions to feed into the AER's review process, including the series of expert concurrent sessions known as "hot tubs".

Energy Networks Australia has prepared a **Rate of Return Engagement Approach** document for this review, which will be updated during the AER's review process.

Early engagement with consumer groups and stakeholders has shown support for Energy Networks Australia's engagement approach, and the need to provide information that is accessible, understandable and in plain English.

Perspectives on the Guideline Review Issues

On 12 December 2017, Energy Networks Australia **lodged a response to the AER's Issues Paper** which asked a series of questions.

Energy Networks Australia's overall objective is for the establishment of a Guideline that is capable of acceptance by stakeholders. At this time we think this could be achieved if the process:

» **builds on the AER's existing Guideline that was finalised in 2013** – we support the AER's incremental approach to reviewing the Guideline, and we believe we should take account of recent Tribunal and Court outcomes;

» **updates the relevant empirical evidence** – this is to ensure the most up-to-date data is considered where it is relevant, and to provide a strong evidence base;

» **provides a predictable, transparent Guideline** – which allows networks, consumers and all stakeholders to understand clearly what data and methods the AER has used and how these have been applied to reach the final outcome;

» **results in more stable outcomes** – this is to ensure the outcomes of the process provide a stable Rate of Return. This will build on past reforms that seek to remove volatility from network charges for customers.

Setting the Overall Allowed Rate of Return

We support the AER's 'Foundation Model' approach to determining the return on equity allowance. Under this approach, the AER uses a primary asset pricing model (the Sharpe-Lintner Capital Asset Pricing Model) and then uses additional evidence from other models to ensure that the estimates of the inputs to the foundation model are as accurate and reflective of prevailing market conditions as possible.

We also think it is important that the AER explain transparently how it uses the evidence available to arrive at its conclusions. In this task, some regulatory judgement and discretion will play a role. However, it is important that any regulatory judgment or discretion be set out clearly and in full so that all stakeholders can understand the basis for the AER's decisions, and can independently replicate the AER's analysis to arrive at the same or similar conclusions. Such an approach would enhance all stakeholders' confidence in the regulatory framework, and promote a more collaborative and constructive regulatory process.

The AER's Process for Reviewing the 2013 Rate of Return Guideline

Date	Milestone
October 2017	AER Issues Paper released
8 December 2017	Submissions on Issues Paper close
February-March 2018	Concurrent evidence sessions
May 2018	AER publish draft Guideline
June-August 2018	Independent Expert Panel process
August 2018	Submissions on draft Guideline
17 December 2018	AER publish final Guideline

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Perspective on Detailed Guideline Areas

The table below sets out a summary of initial positions discussed in the Energy Networks Australia submission to the AER's Issues Paper.

Item	Energy Networks Australia
Overall Rate of Return	
Benchmark Gearing and Term of debt	To keep a gearing (debt to total value) ratio of 60%. Recent evidence supports this. To estimate gearing based on market values. This approach is consistent with: » how other Rate of Return parameters are estimated and » standard commercial and regulatory practice. To keep the term of debt to 10-years as most firms are already part-way through the 10-year transition adopted by the AER in its 2013 Guideline.
Averaging or 'Measurement' Periods	Cost of Debt – to continue to allow businesses to set their averaging periods ahead of time, but allow businesses greater flexibility over the length of the averaging period, to better align their actual cost of debt with the regulatory allowance. Cost of Equity - to consult further with stakeholders about adopting a longer averaging period (and/or adopt a market risk premium that better reflects prevailing market conditions) to reduce volatility in the cost of equity, to enhance the stability of the return on equity allowance.
Return on Debt Allowance	
Transition to 10-year trailing average approach	No change to the return on debt transition arrangements. The key reason is most networks are part-way through the transition to the 10-year averaging period, and have already put financing arrangements in place. Adoption of different transitional arrangements would likely require businesses to put in place new financing arrangements, potentially imposing significant costs on consumers and networks.
Estimating the cost of debt	Support the AER's general approach to calculating the return on debt allowance and considering whether new data sources are robust.
Return on Equity Allowance	
Market Risk Premium (MRP)	Support an approach that provides a stable, predictable and reasonable return on equity allowance that has proper regard to the evidence on prevailing market conditions. Encourage the use of the AER's Dividend Growth Model (DGM) as material evidence to inform the estimate of the MRP. Encourage the use of the Wright approach to inform the estimate of the MRP. Encourage the consideration of evidence from independent expert valuation reports to estimate the MRP.
Equity Beta	Propose that: » a reasonable number of comparator firms be used and to not use historical data from firms that have been delisted for some years; » all equity beta estimates be re-levered using a common gearing level, consistent with standard finance practice; » the AER extend its evidence to other domestic infrastructure businesses and relevant international comparators to create a sample size that would increase the statistical reliability of the equity beta estimate; and » that the established 'low-beta bias' problem be accounted for properly when estimating the equity beta.
Imputation Credits (Gamma)	We will work with the AER to implement the utilisation rate interpretation when estimating gamma. Propose that the AER: » use the ATO tax statistics approach to estimate gamma as this approach provides a reliable and direct estimate of the utilisation rate » identify all relevant evidence, explain why it is relevant and how it has been used; and » explain the role of ranges in developing its gamma estimate.