4 May 2018

Mr Warwick Anderson
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Via: rateofreturn@aer.gov.au

Dear Warwick

AER Discussion Papers -Review of the Rate of Return Guideline

SA Power Networks, Australian Gas Infrastructure Group, CitiPower, United Energy and Powercor (**the Businesses**) are pleased to provide this submission in response to the following discussion papers published by the AER in February 2018 and the two concurrent evidence sessions on these topics held in March and April 2018:

1. Gearing Discussion Paper
2. Risk and judgment Discussion Paper
3. Financial performance measures Discussion Paper
4. Gamma Discussion Paper
5. Equity Beta Discussion Paper
6. MRP, Risk Free Rate Averaging Period and Automatic Application Discussion Paper

The Businesses note their input into and support of the submissions also provided by Energy Networks Australia on these matters. This submission highlights matters arising from the above Discussion Papers and concurrent evidence sessions that we consider are particularly important in moving towards a draft Rate of Return Guideline.

A Guideline that is capable of being accepted

We have previously noted our support for developing a Guideline that is capable of being accepted by all stakeholders. This means producing a Guideline that:

1. Is based on a robust evidence base
2. Follows transparent, fair and consistent treatment of the evidence
3. Has allowed all stakeholders an opportunity to provide input into the development of the Guideline and to have their issues considered.
4. Produces stable and predictable outcomes

The result ought to be a Guideline which is considered by all stakeholders as a reasonable approach to deriving the rate of return and gamma and one which contributes to the achievement of the national electricity and gas objectives (**NEO/NGO**) to the greatest degree.

The AER's concurrent evidence sessions have been a very positive step towards the development of a Guideline which is capable of acceptance by all stakeholders. The Businesses are highly supportive of the approach to date and we look forward to further constructive outcomes in the return on debt concurrent sessions forthcoming.

The value of the sessions is evidenced by the Expert Joint Report dated 21 April 2018 and while there are clearly still areas where expert views differ (as expected), there are also some important areas where consensus has been reached, or where areas of disagreement have been narrowed including for example:

1. The experts agreed that all risks, systematic and non-systematic, must be accounted for in the framework and there should be an identification of where the allowance for each relevant risk is addressed.[1]
2. There was agreement that stability and predictability are important principles in the regulatory context and benefit all stakeholders and the AER should have a high regard to these benefits.[2]
3. Broad consensus that the foundation model approach should be retained.[3]
4. Broad consensus on the approach to estimate gearing, with most experts concurring that there is no new evidence to challenge the use of a 60% gearing ratio.[4]
5. In relation to equity beta, broad consensus that:
    a. Estimating equity beta from market data is appropriate.[5]
    b. De-levering to estimate asset beta and re-levering to the assumed gearing is appropriate.[6]
    c. The shrinking of the domestic samples is a problem, but that recently de-listed firms, international energy firms and other domestic infrastructure firms can provide relevant information.[7]
6. In relation to the MRP, broad agreement that:
    a. Backward looking (historic) estimates are relevant, as are forward looking estimates such as dividend growth model estimates and both play a role.[8]
    b. Historical returns should use long time periods.[9]

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[1] Expert Joint Report, 21 April 2018, section 2.21, page 24
[2] Expert Joint Report, 21 April 2018, section 2.02, page 14
[3] Expert Joint Report, 21 April 2018, section 2.12, page 18.
[4] Expert Joint Report, 21 April 2018, page 5.
[5] Expert Joint Report, 21 April 2018, section 5.01 page 39
[6] Expert Joint Report, 21 April 2018, section 5.01 page 39
[7] Expert Joint Report, 21 April 2018, section 5.09, pages 43-47.
[8] Expert Joint Report, 21 April 2018, section6.01, page 57.
[9] Expert Joint Report, 21 April 2018, section 6.05, page 59

c. The main issue around the use of dividend growth model estimates relates to long-term dividend growth rates.[10]

In developing the draft Guideline, the Businesses urge the AER to reflect and build upon the outcomes of the concurrent evidence sessions and in particular matters on which there is broad consensus.

Where there remains differences of approach or views between experts, it is important for there to be a fair and balanced assessment of all the evidence. Importantly, there should be consistency in the treatment of the evidence relied upon in considering each of the relevant parameters. By this we mean:

1. Evidence required to move away from an existing position needs to be of similar weight and reliability to the evidence that established the position in the first instance.
2. Where there are matters of contention, all evidence should be treated the same and only robust and reliable evidence should be used to settle those issues.

A minimum threshold of reliability and robustness should be applied to all evidence assessed in order to ensure the best possible estimate of each parameter and a Guideline which is capable of acceptance by all stakeholders. The Energy Networks Australia submission presents approaches to each parameter which are supported by robust empirical evidence and well-accepted methodologies and the Businesses endorse that approach.

An incremental approach and the 2013 Guideline

The Businesses continue to support an incremental approach to the Guideline review. A significant amount of analysis, expert opinion and precedent underpins the 2013 Guideline and significant investment in networks has been undertaken on the basis of that Guideline. The threshold for any material changes from the current Guideline should be considered to be high given there has been no material change in finance theory since the 2013 Guideline and the need to ensure regulatory certainty and stability in order to further the NEO/NGO.

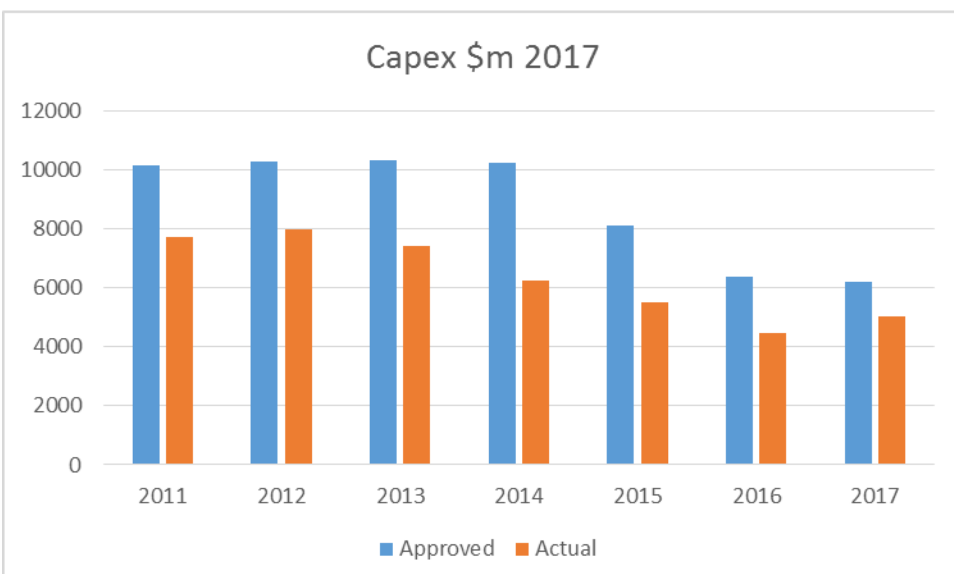
As a starting point, it is instructive to consider the impact of the rates of return arising from the application of the 2013 Guideline. The Businesses submit that there are a number of indicators that the rates of return arising from the 2013 Guideline are not too high. Those indicators are:

1. **Reduction in return on equity allowances** -since the 2013 Guideline, there has been a significant drop in CGS yields used as a proxy to estimate the risk free rate. As the Energy Networks Australia submissions shows, the AER's allowed return on equity has fallen in line with reductions in CGS yields.

[10] Expert Joint Report, 21 April 2018, section 6.06, page 60.

Figure 1: Allowed return on equity since the 2013 Guideline[11]

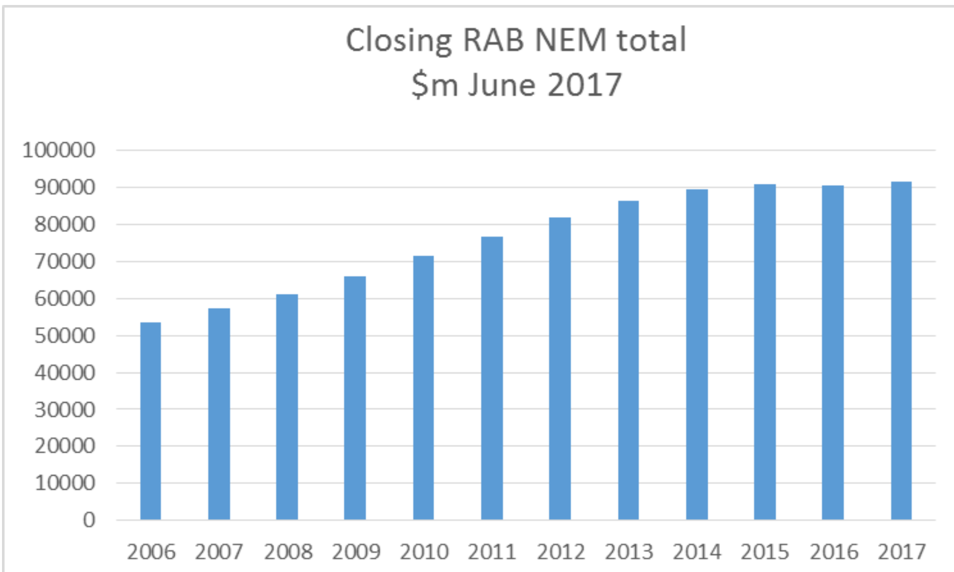
2. **Capex Spend-** The Energy Networks Australia submission also shows that the majority of networks have underspent capex allowances since the 2013 Guideline.[12] A similar trend of underspending of capex allowances can be seen from the following chart showing NEM total approved capex and actual capex spend (derived from the AER's RIN data provided to the Businesses)



[11] Extracted from section 3.1 of the Energy Networks Australia submission.
[12] ENA Submission, section 3.3, Figure 5

This pattern of underspending capex allowances is consistent with an incentive based regime which encourages efficiency, but is not consistent with there being excessive returns available which would encourage a pattern of overspending on capex allowances.

3. **RAB growth-** the Energy Networks Australia submission shows that since the 2013 Guideline, there has been little growth in RABs of electricity networks.[13] The pattern of minimal RAB growth and a flattening out of RAB growth in the National Electricity Market as a whole since 2014 is also supported by the RIN data provided to the Businesses by the AER from which the following chart is derived:



The minimal growth in RABs since the 2013 Guideline indicates the rates of return derived from the Guideline have not resulted in any over investment in networks.

4. **Comparative rates of return-** Section 3.4 of the Energy Networks Australia submission includes a comparison of allowed equity risk premium across a number of international jurisdictions. That analysis shows that the AER's allowed equity risk premium (equity beta of 0.7 x MRP of 6.5%) based on the 2013 Guideline is an outlier and returns available in other jurisdictions are materially higher. Investors in our Businesses have interests in these jurisdictions (eg NZ and the UK). Rates of return that are out of step with jurisdictions with whom we compete for capital reduce incentives for efficient investment in Australian networks which is not in the long run interests of consumers.

It is evident from the matters outlined above that the rates of return arising from the 2013 Guideline cannot be considered to be too high and in fact may be at a level that is constraining efficient investment in networks. The Businesses submit that this should lead the AER to an approach in this Guideline review that:

[13] ENA submission, section 3.2, Figure 4

1. Starts from the premise that the 2013 Guideline should set the base line for the review.
2. That parameter estimates should be updated and any new evidence considered, but the threshold for any change in methodology or in the relevant parameter estimate should be high.
3. Any change in the approach or parameter estimate should only occur if there is robust and reliable evidence that the parameter estimate is no longer the best estimate possible in the circumstances and will not give rise to rate of return or gamma that contributes to the achievement of the NEO/NGO to the greatest degree.

This approach is consistent with ensuring there is certainty and stability in the regulatory process, a matter which all experts agreed is important, and which is required if networks are to attract the funding necessary to efficiently invest in their networks.

Specific parameters

As noted above, the Businesses endorse the Energy Networks Australia submission regarding the approach to individual parameters. We make the following observations by way of emphasis:

1. **Gearing-** it should be uncontroversial that the appropriate benchmark gearing assumption remains 60%. The AER's updated analysis of gearing continues to support this assumption and the experts in the concurrent evidence sessions broadly agreed that there is no new evidence that suggests this assumption is incorrect.
2. **Equity beta-** The Businesses submit that the evidence presented in the Energy Networks Australia Submission on equity beta and the existence of the low beta bias is robust and reliable and would meet the threshold for an adjustment (upwards) to the equity beta from the 0.7 estimate in the 2013 Guideline; certainly there is no case for reducing the beta allowance.

3. **MRP-**as noted above, all experts agreed that regard should be had to both historic excess return data, as well as forward looking estimates of the MRP, and that the NERA historical estimates and Wright CAPM should play some role in the former and the DGM should play some role in the latter. As the Energy Networks Australia submission shows, that evidence, when considered in its totality, supports an MRP above the 6.5% estimate from the 2013 Guideline as almost every piece of evidence the AER relies upon in deriving the MRP has increased materially since 2013.[14] There is no case to be made for reducing the MRP allowance.

4. **Gamma-** the utilisation rate approach to gamma is not being challenged as part of this Guideline review. However, experts agree that the approach does not have a consistent basis in finance theory, and the task is to derive a pragmatic outcome which is capable of acceptance by stakeholders rather than to derive an answer based on theoretical models or principles. We consider, as outlined in the ENA submission, that this approach involves estimating the expected proportion of company tax which is returned to investors through utilization of imputation credits. ATO tax statistics provide a direct estimate of the proportion of company tax paid by the average firm that is returned to its investors through utilization of

[14] ENA Submission, section 7.4.

imputation credits. The items in the ATO data base required for this estimate are reliable and robust and give rise to an estimate for gamma of 0.34. The Businesses submit that this evidence meets the threshold for a change in the estimate of gamma from the 2013 Guideline and the AER's recent decisions.

Please contact Patrick Makinson on (08) 8404 5865 if you would like to discuss this submission further.

Yours sincerely

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