Energy Networks Australia

MEMORANDUM

Date	23 October 2018
To	AER Board Members Ms Paula Conboy, AER Chair Ms Cristina Cifuentes Mr Jim Cox
CC	Mr Warwick Anderson General Manager, Networks (Finance and Reporting) Mr Esmond Smith Director, Rate of Return
From	Mr Andrew Dillon CEO, Energy Networks Australia

Review of Rate of Return Guideline

Response to AER Board Questions – International comparisons

This memorandum provides a further response to questions raised in Energy Network Australia's (ENA) discussion with the Australian Energy Regulator Board on 4 October on international return on equity and cost of capital comparisons.

Background

In the ENA presentation to the AER board on 4 October 2018, ENA made a number of comparisons between the AER's allowed equity risk premium (ERP) and that allowed by regulators overseas. That analysis demonstrates that the ERP allowed by the AER is materially lower than international benchmarks.

The reasons for presenting comparisons at the ERP level are:

- The AER has consistently stated that such comparisons should be performed at the ERP level;[1]
- All of the cross checks considered in the current Draft Guideline have been performed at the ERP level;[2]
- The ERP enables relatively straightforward like-with-like comparison to be made; and
- It is equity investors who are the ultimate residual claimants on the cash flows of the firm, and who ultimately decide whether the firm should keep investing or not. Therefore, it is appropriate to evaluate whether equity investors are being compensated appropriately, particularly when it is open to those equity investors to move their capital to regulated assets in other jurisdictions if they are not appropriately compensated in Australia.

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[1] This is documented in the ENA submission of 25 September 2018 at p. 69.
[2] See the summary in Section 7 of the ENA submission of 25 September 2018, beginning at p. 68.

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Request for further information

During that presentation, the AER Board asked ENA representatives what the comparison would look like if performed at the level of the weighted average cost of capital (WACC) level, rather than at the ERP level.

This note:

- Explains why it is difficult to perform like-with-like comparisons at the WACC level; and
- Sets out our best efforts at a comparison at the WACC level for two key international comparators – Ofgem and the New Zealand Commerce Commission (NZCC) .

The result is that the WACC allowance proposed in the Draft Guideline is materially lower than the international benchmarks.

Considerations to ensure a like-with-like comparison of WACC allowances

Preparing a like-with-like comparison at the WACC level is a difficult task for a number of reasons including:

- Some regulators (e.g. FERC in the US) do not publish a WACC in their decisions. Rather, they publish an allowed return on equity and treat the return on debt as an operating cost;
- Some regulators quote WACC in real terms and others use nominal terms;
- Some regulators quote WACC on pre-tax terms, some use a vanilla WACC and others use a post-tax specification;
- Some regulators adjust the allowed return on equity for imputation credits and others apply an adjustment to the corporate tax allowance; and
- Different regulators adopt different methodologies for determining the return on debt allowance.

Consequently, a series of adjustments may be required to ensure that the WACC allowances are stated on the same (comparable) basis. The required adjustments are unique to the specific details of each case.

Approach to preparing comparable WACC allowances

In this note, we prepare comparable (post-tax vanilla) WACC allowances for Ofgem and the NZCC. In computing these figures we:

- Convert real allowances into nominal figures using the relevant regulator's inflation estimate;
- Convert imputation-adjusted parameters to the same basis as used by the AER (e.g. convert the NZCC tax-adjusted MRP into an MRP that is comparable to the AER's specification);
- Remove debt issuance costs from the allowed return on debt; and

» Express the WACC on a vanilla nominal post-tax basis, geared to 60% to ensure comparability with the AER's allowance.

As a point of comparison, for the AER's WACC allowance the analysis:

» Adopts the allowed return on equity parameters set out in the Draft Guideline;
» Sets the risk-free rate to 2.7%; and
» Sets the allowed return on debt using the approach set out in the Draft Guideline. This corresponds to the allowed return on debt for a firm that is beginning its transition to the trailing average approach. Individual firms that are part-way through their transition will potentially have a somewhat higher or lower allowed return on debt in the short-term.

The resulting vanilla post-tax WACC allowances are set out in the table below.

As for the ERP comparison, the WACC comparison indicates that the AER's proposed allowance is materially below that of international benchmarks.

Regulator	Post-tax vanilla WACC allowance
AER	5.12%
Ofgem	5.80%
NZCC	5.75%

Sources:

1. *The information used to calculate the AER post-tax nominal WACC was obtained from:*
    a. *2018 Draft Rate of Return Guideline; and*
    b. *Reserve Bank of Australia.*
2. *The information used to calculate the Ofgem post-tax nominal WACC was obtained from:*
    a. *Ofgem, RIIO-2 Framework Consultation: Our approach to setting price controls for GB gas and electricity networks, March 2018, Table 4, p. 90;*
    b. *CEPA, Review of cost of capital ranges for Ofgem's RIIO-2 for onshore networks, February 2018, Tables 4.1 and 7.1; and*
    c. *CEPA, Review of cost of capital ranges for new assets for Ofgem's networks division, January 2018, p. 59.*
3. *The information used to calculate the NZCC post-tax nominal WACC was obtained from:*
    a. *NZCC, Cost of capital determination for disclosure year 2019 Electricity distribution businesses and Wellington International Airport [2018] NZCC 7, 30 April 2018, p. 4.*

Update to FERC return on equity and resulting ERP estimate

Slide 5 of the ENA presentation provided an interim ERP estimate (of 8.07%) based on case notes in an ongoing Federal Energy Regulatory Commission (FERC) proceedings related to the *Emera Maine v. FERC* case.

On 16 October 2018, the FERC in the US published an Order that set out a revised methodology for determining the return on equity (following the *Emera Maine v. FERC*

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judgment), and which also presented a preliminary estimate of the return on equity for a number of electricity transmission operators.[3]

In that new Order, FERC derived a return on equity estimate of 10.41%. As explained in the Order (p. 40), FERC's usual practice is to estimate the risk-free rate using the yield on 30-year US Treasury bonds. The average yield on 30-year Treasury bonds over the 20 trading days to 16 October 2018 was approximately 3.27%.[4]

Therefore, the ERP implied by FERC's 16 October 2018 Order is 7.14%, which is materially higher than the ERP allowed by the AER in the 2018 Draft Guideline.

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[3] 165 FERC ¶ 61,030, Docket No. EL11-66-001, et al., 16 October 2018.
[4] Data from: https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2018