9 October 2020

Mr [redacted]
General Manager, Networks Finance and Reporting
Australian Energy Regulatory (AER)
GPO Box 520
Melbourne Vic 3001

Dear [redacted]

DRAFT WORKING PAPERS: RETURN ON EQUITY

Endeavour Energy appreciates the opportunity to respond to the AER's draft working papers on its review of *International regulatory approaches to the rate of return* and the *Capital Asset Pricing Model (CAPM) and alternative return on equity models.* These papers are respectively informed by expert advice provided by the Brattle Group and Partington and Satchell.

In our response to the draft working papers we provide this brief response highlighting our key positions. For a more detailed position we refer the AER to the ENA's submission to this review, which we fully endorse.

We are supportive of the process the AER has undertaken to date, which includes new expert perspectives and an open and broad review of the component parts of the Rate of Return Instrument (RORI). It will be important that this engagement and an evidenced based review of the issues is reflected in the outcomes of the 2022 RORI. The objective of this process should be to set a return on equity that forms part of an overall return that is commensurate with the efficient financing costs of a benchmark regulated energy network. In our view, this is a return that is reflective of rates in the market for capital finance that real world investors require and one that will remain so as market conditions change throughout the course of a determination period.

The 2018 RORI is now delivering a real return on equity that is 2.35 per cent (an all-time low) following falls in the government bond yields and is well below that adopted by comparable regulators which is not pragmatic. An approach that results in benchmark efficient networks incurring losses in each year of a regulatory period is not sustainable and inconsistent with the efficient investment in, and operation of, a network.

We have concerns that the Partington and Satchell advice, if relied upon, will simply produce the same outcomes for the 2022 RORI. Our concern is that their advice implies that the current method cannot be improved upon. Instead, it subjects all CAPM alternatives or variations to a higher degree of scrutiny and simply asserts a series of potential estimation issues which preclude these alternatives from being relied upon in any manner, without testing whether these issues arise in relevant data or considering how these issues might be addressed or corrected.

There are clear and obvious differences between various regulators, and outcomes from the 2018 RORI in practice, that require thorough investigation. Rather than select the available evidence to defend historical positions, a balanced assessment is required. There needs to be a robust framework for assessing evidence that results in a proportionate level of scrutiny being applied to a piece of evidence that is commensurate with the weight it is given and its position relative to orthodox financial theory and commercial practices.

The Brattle report highlighted the following areas the AER could review in improving its approach for the 2022 RORI:

1. incorporating forward-looking evidence into the cost of equity;
2. use of multiple models for estimating the cost of equity;
3. increasing the frequency with which the cost of equity is updated; and
4. updating the approach to equity beta estimation.

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We support the CAPM being relied upon as the primary model but consider these suggested focus areas would guide the AER's review of how it implements the CAPM. The AER's approach would be improved by implementing meaningful cross-checks, giving weight to a broader set of evidence (particularly forward-looking information and international comparators) and acknowledging that the allowed return does not vary 1:1 with changes in government bond yields.

In addition to these broader considerations, the AER's working paper on *CAPM and alternative return on equity models* invites comments on a number of specific issues. Our preliminary responses to these issues are as follows:

1. **The CAPM is to be used to set the allowed return on equity:** we agree with this proposition.
2. **The use of forward-looking information to estimate the Market Risk Premium (MRP**): we support the use of historical excess returns data but consider it is backward-looking and should be complemented by forward-looking evidence – most notably the Dividend Growth Model (DGM). Consideration should also be given to the *Wright approach* when estimating the MRP given the implausibility of assuming the MRP remains constant in all conditions.
3. **The relationship between the MRP and risk free rate:** we note that legislation prevents the AER from updating all equity parameters throughout a determination period (which should be reviewed if sub-optimal) and caution against only partially updating the return on equity. We support further consideration of adopting a formulaic approach to update the MRP for changes in the risk-free rate or other market evidence such as particular DGM estimates.
4. **Estimating Beta:** the current approach uses a small and diminishing sample of firms (now only three live domestic firms). We do not consider the long term period corrects for this limitation and recommend that a range of approaches are used which includes a broader and international dataset along with different historical periods, return frequencies, reference days, etc. With respect to international data this could include beta estimates for comparable firms adopted by comparable regulators.

If you have any queries or wish to discuss our submission further please contact [redacted] Regulatory Strategy Manager at Endeavour Energy on [redacted] or via email at [redacted]

Yours sincerely

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[redacted]
Deputy Chief Executive Officer