11 May 2018

Mr Warwick Anderson
General Manager, Networks
Australian Energy Regulator
GPO Box 3131
Canberra, ACT, 2601

Lodged electronically: rateofreturn@aer.gov.au

Dear Mr Anderson

EnergyAustralia Pty Ltd
ABN 99 086 014 968

Level 33
385 Bourke Street
Melbourne Victoria 3000

Phone +61 3 8628 1000
Facsimile +61 3 8628 1050

enq@energyaustralia.com.au
energyaustralia.com.au

AER – Review of the rate of return guideline – Evidence Sessions – 4 May 2018

EnergyAustralia welcomes the opportunity to inform the AER's review of the rate of return guideline. We are one of Australia's largest energy companies with over 2.6 million electricity and gas accounts in New South Wales, Victoria, Queensland, South Australia, and the Australian Capital Territory. We also own and operate a multi-billion dollar energy generation portfolio across Australia, including coal, gas, and wind assets with control of over 4,500MW of generation in the National Electricity Market and an annual gas portfolio of over 100PJ.

The AER has invited submissions in response to its Evidence Sessions. We have limited our comments to the return on equity parameters. We note the AER will be releasing a further discussion paper on the return on debt.

We consider that, by themselves any single one of the rate of return parameters is not an unreasonable estimate. However, when considered in aggregate, the level of conservatism applied results in a rate of return calculation biased more towards ensuring an adequate rate of return for network businesses, and less to ensuring an affordable outcome for consumers of gas and electricity.

We suggest the AER take a more balanced approach, by selecting values for each parameter that are more towards the mid-point of the calculated range. This would ensure that the allowed rate of return for a network business is commensurate with the efficient financing costs of benchmark efficient entity with a similar degree of risk. It would also be more consistent with meeting the National Electricity Objective and the National Gas Objective.

Return on equity

Equity Beta

Equity beta is a key parameter in the Sharpe-Linter Capital Asset Pricing Model (CAPM) used by the AER. The AER bases the calculation of the equity beta on empirical estimates of the standardised correlation between the value of the market portfolio and a set of firms that approximate the risks involved in providing energy network services. This approach to date has produced an equity beta range of 0.4 to 0.7.

While we consider this approach by the AER to be reasonable, when applying a point estimate of 0.7, this leads to a level of conservatism in the rate of return calculation. The equity beta has remained at 0.7 since 2013.

A more appropriate approach would be to use the median of the data points within the range. We understand that the AER use the upper end of the estimated range, as:

- there have been some arguments that the Black CAPM is more appropriate than the Sharpe-Linter CAPM; and
- studies have shown that the Black CAPM leads to a higher beta estimate than the Sharpe-Linter CAPM (for beta's below 1).

We suggest that either the Black CAPM should be used in its entirety, or the Sharpe-Linter CAPM in its entirety. By using this as an argument to choose the upper bound, it may well be that the Black CAPM produces a best estimate that is different to the 0.7 that has been selected in this case.

After assessing all the evidence available on the Black CAPM, the AER noted a range of limitations, such as its empirical instability and difficulty to implement. Instead we recommend the AER focus on ensuring the best estimate from the Sharpe-Linter CAPM is applied, as it is a model widely used to ascertain an appropriate weighted average cost of capital.

Market risk premium

With regard to the market risk premium, we again note that the AER applies a point estimate at the upper end of the historical average range. Again, our concern is that this brings a level of conservativism that results in higher rate of return compared to the actual costs of the entities.

We recommend that a point within the range of historical averages be used, with the midpoint being considered appropriate. KPMG in its 2017 Valuation Practices Survey[1] found that 6 per cent remains the most commonly adopted market risk premium for Australia. This market risk premium is below the 6.5 per cent that the AER has adopted since 2013.

If you would like to discuss this submission please contact Carmel Forbes on (03) 8628 1596.

Regards

Kerryn Graham
Head of Risk and Analytics

[1] https://assets.kpmg.com/content/dam/kpmg/au/pdf/2017/valuation-practices-survey-2017.pdf, p.g.11