

Date 26 June 2018
To Australian Energy Regulatory Board Members
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From Andrew Dillon, CEO, Energy Networks Australia

Regulatory discretion and market risk premium determination

Response to AER Board request for further views

Background

The Australian Energy Regulator (AER) Board asked Energy Networks Australia (ENA) on 17 May for further views on how the AER might document how it has gone about exercising judgment when determining the allowed market risk premium (MRP) under the Rate of Return Guideline framework (the Guideline).

Clear identification of the objective for the MRP estimate

Energy Networks Australia considers that the AER should begin by clearly identifying its objective in setting the MRP in the Guideline.

ENA considers that the appropriate objective is to determine the MRP that (when combined with the prevailing government bond yield) produces an allowed return on equity that is commensurate with the prevailing required return on equity in the market at the time of the Guideline.

Explanation of the exercise of judgment

The allowed MRP will be informed by a range of evidence and estimation methods that will have to be distilled into a single estimate. This will inevitably require the exercise of judgment.

ENA has submitted that the Guideline should explain the exercise of judgment so that stakeholders are able to understand *how* the final estimate was derived from the relevant evidence.

The options available to the AER for explaining how it has exercised judgment would seem to include the following:

1. Assign specific numerical weights to each relevant piece of evidence.

Other regulators do this (e.g. the Queensland Competition Authority has recently published a set of weights, WA Economic Regulation Authority explains its process for each determination in a detailed step-by-step fashion, NSW IPART and New Zealand Commerce Commission assign specific weights to each piece of evidence). If the weights change from those adopted in the previous Guideline, the AER would identify the evidence that led to the change. The AER will also specify whether it uses a mean or median to combine the evidence.

2. Set out a ranking of weights applied to each piece of evidence.

Under this approach, the AER would not assign specific numerical weights to each piece of evidence, but would rank each piece of evidence in terms of the relative weight applied in reaching the final MRP allowance. If the ranking changes from that adopted in the previous Guideline, the AER would identify the evidence that led to the change.

3. Start with a 'neutral' long-run estimate (e.g., 6% long-run average MRP or 11% long-run average total market return) and qualitatively consider whether the evidence suggests the current MRP (or Total Market Return) is higher or lower.

For example, one possibility is that (but for extraordinary circumstances) the AER might indicate that its MRP allowance would be either 5%, 5.5%, 6%, 6.5% or 7% and that its default is 6%, it will adopt 6.5% if there is 'solid/strong' evidence that current risk premiums are higher than average, and 7% if there is 'very strong' evidence that risk premiums are 'materially' above average.

Energy Networks Australia views

Energy Networks Australia has submitted that the Guideline should explain the exercise of judgment so that stakeholders are able to understand how the final estimate was derived from the relevant evidence.

Ultimately the AER will apply some weight to each piece of evidence when distilling the range of evidence into a single allowed MRP. ENA advocates that those weights be disclosed in the interest of transparency – either explicitly or at least in the form of a ranking of the importance of each piece of evidence.

We also consider that two principles that are very important for stakeholders are:

1. **Consistency over time** – the same evidence should produce the same outcomes over time; and
2. **Evidence-based decision-making** – any change from one Guideline to another should be supported by a change in the relevant evidence.