3 September 2021

Warwick Anderson
General Manager
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Dear Warwick

RATE OF RETURN - OMNIBUS PAPERS

Energy Queensland Limited (Energy Queensland) welcomes the opportunity to comment on the Australian Energy Regulator's (AER's) three draft working papers on the Overall rate of return, Equity and Debt (the Omnibus Papers) published on 15 July 2021. We continue to support the AER's early engagement with stakeholders on key rate of return issues in the lead up to the formal 2022 Rate of Return Instrument (RoRI) development phase.

Energy Queensland is a member of Energy Networks Australia (ENA) and endorses the comprehensive submissions from the ENA. We also wish the make the following comments on the aforementioned omnibus papers.

Overall rate of return draft working paper

Nominal Vanilla Weighted Average Cost of Capital (WACC)
Energy Queensland supports the continuation of the established practice of using a nominal vanilla WACC. We agree with the AER that this approach is simple, transparent, and consistent with the treatment of value of imputation credits (gamma).

Gearing
We support the use of market-based measures to measure the benchmark gearing ratio. Further, we submit that the AER should adopt a consistent approach to the treatment of hybrid securities in measuring gearing and the return on debt allowance.

Gamma
We broadly support the AER's current approach to estimating gamma. Energy Queensland also welcomes the AER's review of the private Australian Taxation Office data and its potential use in informing the utilisation rate.

Equity draft working paper

Market risk premium (MRP) and equity beta
In estimating the MRP and equity beta parameters used in the Sharpe-Lintner Capital Asset Pricing Model to determine the return on equity, the AER's 2022 RoRI must have proper regard to a broad set of evidence. It is unreasonable for the AER to retain its 2018 RoRI approach of placing undue weight on a very small subset of the relevant evidence in estimating these parameters.

We welcome the AER's signalling of its openness to revaluating its approach to estimating the MRP and the relationship between the MRP and risk-free rate. In the 2018 RoRI, the AER relied exclusively on historical excess returns. However, the Brattle Group[1] and CEPA[2] expert reports recently commissioned by the AER, provide compelling evidence that the AER's approach is an outlier relative to the approaches commonly used by other regulators.

We consider that historical excess returns, the Wright approach, and dividend growth models are relevant evidence that should have a primary role in informing the MRP estimate in the 2022 RoRI. These approaches are widely adopted by other regulators and can be pragmatically applied by the AER.

Similar to the MRP, Energy Queensland reiterates that the AER must have regard to a wider set of evidence. The AER must not continue to rely on long-delisted Australian firms as this will not reflect the present risks facing energy networks. The AER continues to defend its approach on the basis that the equity beta is relatively stable. However, this has not been borne out in the AER's decisions where it has materially reduced the equity beta in three successive rate of return reviews (2009, 2013 and 2018).

Energy Queensland submits that the AER must have regard to international firms and reconsider the low beta bias issue in estimating the equity beta.

Cross checks
Cross checks have an important role in estimating the return on equity given the obvious imprecise nature of the exercise and the significant discretion and judgement required on the part of the AER. There are limitations associated with all the relevant evidence. Different choices on estimation methods, models, and data can produce wide disparities in the return on equity estimates. In this context, to estimate the best possible return on equity, the AER must properly have regard to cross checks.

We note that cross checks have not previously played any influential role in the AER's decision making. In the 2018 RoRI, despite the AER's equity risk premium failing almost all of the AER's cross checks, the AER was not persuaded to reconsider the reasonableness of its decision to materially cut the equity risk premium by 19.56%, to 3.66% from 4.55%. The subsequent decline in the risk-free rate has left network businesses facing unreasonably low rates of return under the current 2018 RoRI. Cross-checks, if properly considered, should compel the AER to revisit the appropriateness of some of the judgement applied at the parameter level.

Debt draft working paper

Energy Infrastructure Credit Spread Index (EICSI)

[1] Brattle Group, June 2020, A review of international approaches to regulated rates of return.
[2] CEPA, June 2021, Relationship between RFR and MRP.

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We reiterate our concerns with the AER's proposed expansion of the role of the EICSI in the 2022 RoRI. The EICSI is an attempt by the AER to estimate the actual debt costs incurred by network businesses. The AER used the EICSI as a 'sense check' of its benchmark approach in the 2018 RoRI but is proposing to use the index to determine the blend of A and BBB rated bonds in estimating the return on debt.

Energy Queensland consider this to be a significant and fundamental shift in the setting of the return on debt allowances. Thus, it is incumbent on the AER to ensure that the EICSI is transparent, replicable, robust, and fit for purpose before it plays a more substantial role in the regulatory process. We consider that the EICSI is still in its infancy, a black-box, and has material construction issues that have not yet been settled. We do not currently have any confidence that any outperformance the AER is measuring is properly substantiated and that something (if anything) must be done.

Further, if the AER addresses the abovementioned issues, any subsequent changes to the current benchmark approach from using the EICSI must be internally consistent. For example, if AER determines that the cause of any outperformance measured by the EICSI is due network businesses issuing debt with shorter tenors than the AER's 10 year benchmark, it follows that the AER should change the benchmark tenor with the necessary transition. The AER should not the change the credit rating to address a tenor issue.

Weighted trailing average

We broadly support the use of a weighted trailing average. Energex's and Ergon Energy's regulatory proposals for the 2015-20 regulatory period put forward this approach, however the AER rejected it in favour of the simple trailing average approach.

Should you wish to discuss any aspect of this matter further, please contact Guy Mutasa on [redacted].

Yours sincerely

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Manager Regulation

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