9 October 2020

[redacted]
General Manager
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Email: [redacted]

Dear [redacted]

PATHWAY TO RATE OF RETURN 2022 INSTRUMENT – RETURN ON EQUITY

Energy Queensland Limited (Energy Queensland) welcomes the opportunity to comment on the Australian Energy Regulator's (AER's) draft working papers on the Capital Asset Pricing Model (CAPM) and alternative return on equity models and international regulatory approaches to rate of return. Energy Queensland supports 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 submission from the ENA.

Energy Queensland strongly recommends the AER re-considers its approach to estimating the return on equity for the benchmark firm in the 2022 RoRI. Energy Queensland considers that the 2018 RoRI produced unreasonable return on equity outcomes in the recent distribution determinations for its distribution businesses, Energex Limited (Energex) and Ergon Energy Corporation Limited (Ergon Energy). Under the AER's current return on equity estimation approach, which combines a risk-free rate set to the contemporaneous yield on 10-year Commonwealth Government bonds and a fixed equity risk premium, the return on equity moves one-for-one with changes in the risk-free rate. As a result of a material decline in Commonwealth Government bond yields, the return on equity fell by 20.5% in a 7-month period from when Energex and Ergon Energy submitted their regulatory proposals, on 31 January 2019, to when the AER made its draft decisions, in October 2019. The return on equity declined by a further 6.2% between the AER's draft and June 2020 final decisions, as Commonwealth Government bond yields continued to fall. These reductions were in addition to the 19.6% reduction to the equity risk premium that the AER made in the 2018 RoRI relative to the previous 2013 Rate of Return Guideline.

Energy Queensland submits that changes in the estimated return on equity of such magnitude, in such a short timeframe, are quite unreasonable. The AER has typically rejected a range of evidence advanced by network businesses informing the return on equity citing the instability of estimates, yet the AER's own approach still produces volatile outcomes.

Furthermore, the decline in the risk-free rate (and the required return on equity) to historical lows following the submission of Energex's and Ergon Energy's regulatory proposals, coupled with the AER's approach to estimating inflation, resulted in the AER's post-tax revenue models (PTRM) projecting negative net-profits after tax for Energex and Ergon Energy over the 2020-25 regulatory period.

In Energy Queensland's view, this demonstrates that the AER's approach is not robust in changing market conditions and that the pricing volatility, and negative net-profits projected in the PTRM created by the current approach, are not in the interest of electricity customers or electricity network businesses. As detailed in the ENA submission, the 2022 RoRI must be more robust to changing market conditions and provide return on equity estimates that are consistent with the returns required by real-world investors.

The AER has not changed its return on equity estimation approach in 3 successive rate of return reviews (2009, 2013 and 2018). The AER has relied on the Sharpe-Lintner CAPM exclusively, with the risk-free rate set to the contemporaneous yield on 10 year Government bonds, equity beta calculated from regression analysis of a small sample of domestic firms and the market risk premium (MRP) estimated primarily from historical excess returns. Based on its small subset of evidence, all the AER has done is to progressively reduce the equity beta in each review and the MRP in the last review. Unsurprisingly, the returns on equity for Australian energy networks are now the lowest amongst all regulators in the world as demonstrated in the AER's recently commissioned Brattle Group report.[1]

While we endorse the use of the CAPM as the primary tool for estimating the return on equity, we consider that the AER must genuinely widen its sources of evidence in informing the CAPM parameters. We agree with the Brattle report proposal that the AER must consider more forward looking evidence especially in estimating the MRP. We note that the AER continues to unfairly dismiss the use of the dividend growth model by simply outlining a laundry list of estimation issues when the same issues equally apply to the CAPM. We consider that if the AER was sincerely open to using the model, many of the issues can be pragmatically resolved.

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

Yours sincerely

[redacted]

[redacted]
Manager Regulation

Telephone: [redacted]
Email: [redacted]

[1] Brattle Group, June 2020, A review of international approaches to regulated rates of return.