25 September 2018

Mr Warwick Anderson
General Manager, Networks
Australian Energy Regulator
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Lodged electronically: [redacted]

Dear Mr Anderson

EnergyAustralia
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AER – Draft Rate of Return Guideline

EnergyAustralia is 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.

EnergyAustralia welcomes the opportunity to make this submission to the AER's Draft Rate of Return Guideline (the Guideline). In our view, the AER has run a thorough and measured consultation process and we have also appreciated the opportunity to participate in this process through the Retail Reference Group.

The AER estimates that the Guideline will result in a 45-basis point reduction in the overall rate of return compared to the previous approach. We consider that the AER needs to be able to find a balance between ensuring that customers are not paying more than they need to in the short-term and ensuring a sustainable rate of return for networks so that customers can benefit from reliable infrastructure. In our view, the regulatory framework should always consider all factors that contribute to investment choices, particularly any risks in making that investment.

Our submission focuses on three specific parameters – the market risk premium, the equity beta and the return on debt.

Market risk premium

We support the AER's draft decision to place greater weight on historical excess returns (HER) to determine the market risk premium (MRP).

We note that the AER intends to maintain its approach of giving most weight to arithmetic averages (a range of 6%-6.5%) and using the geometric excess return range (4.2%-5.0%) to set the lower bound of the overall HER range. We acknowledge that there is robust debate surrounding which methodology to use. We note that there is a link between the weight given to geometric average returns and the period for which the AER is determining the return on capital. If equity holders expect only to invest for a single year, then using an arithmetic average seems appropriate. If equity holders expect to invest over a longer-term then compounding applies, so a geometric excess return range may provide a better estimate. In practice, there will be range of periods over which equity holders invest for, and as such, we consider the AER's approach to apply both calculation methodologies appropriate.

EnergyAustralia continues to support the use of market surveys to inform AER's MRP, as the surveys reflect market expectations of MRP. We also note that survey evidence since the 2013 Guidelines indicates that the MRP range is consistent with the HER methodology when both arithmetic and geometric returns are calculated. While, it does somewhat lean more towards the arithmetic average calculation methodology, this may reflect the fact that this tends to be a more commonly adopted approach by market practitioners.

The AER has given less weight to Dividend Growth Models. We appreciate that the parameter estimates within this model provide a much more subjective view of the future when compared to other approaches. Energy Networks Australia has stated that these are not new issues, however we believe it is reasonable for the AER to consider all evidence presented to form a view.

From the analysis and evidence provided, it appears the AER is considering the right matters to ensure a fair and balanced outcome for customers. The key issue for MRP appears to be the consideration of the weight that should be given to the geometric excess return range in the HER methodology. We support the Independent Panel finding that the AER should be more transparent in its rationale and information used to determine the MRP.[1]

Equity beta

The draft Guideline shows a reduction in equity beta point estimate from 0.7 to 0.6 and the AER suggest that the best estimate is in fact lower than 0.6.

The longest estimation period is likely to be the most appropriate to use. In determining a range for equity beta, the AER should consider if there has been inclusion of unregulated activities which may be riskier. While the latter point is more difficult to adjust for, we believe that to select the best estimate for the parameter based on the information available, the AER must focus on understanding the underlying data used to prepare the ranges. It is less useful to focus on insignificant changes to the promotion of stability and predictability that arise from small changes in the value of equity beta.

Given the identified shortcomings of the Black CAPM model it seems appropriate for the AER to place less reliance on this model.

Return on debt

In implementing the benchmark credit rating, it appears sensible to use a weighted average of the broad-BBB (weighted by 2/3) and broad-A curves (weighted by 1/3) rather than a broad-BBB series. We agree with the AER that a combination of broad-BBB and broad-A curves is most likely to match the benchmark credit rating of BBB+.

[1] Independent Panel Review of the AER's Rate of Return Draft Guidelines, p.34

We note the Independent Panel's view that the AER has not provided sufficient justification for setting the benchmark term at 10 years,[2] and agree that, if retained, the AER should provide further substantiation.

While network businesses may have a desire to match debt term with asset life, the methodology should aim to reflect actual practice. If the AER were to use a longer-term debt than appropriate, this may result in a level of conservatism in the rate of return calculation and is not providing the appropriate result for customers. The data available to the AER should allow an informed decision on debt terms that reflects what is occurring in practice.

Conclusion

Overall, EnergyAustralia welcomes, and on balance, is supportive of the AER's draft Guidelines. We have provided some additional input on several aspects of the rate of return calculation that could further ensure efficient prices for customers.

If you would like to discuss this submission, please contact Carmel Forbes on [redacted] or at [redacted].

Regards

Kerryn Graham
Head of Planning, Delivery and Performance

[2] Independent Panel Review of the AER's Rate of Return Draft Guidelines, p.37