**Attachment 9-10: Other Rate of Return Issues**

**9.1 Introduction**

The submission responds to the Draft Decision inflation forecast and benchmark gearing ratio as well as addressing a number of rate of return issues raised by the AER in sections 5.5.1 and 5.5.2 of the Draft Decision.

**9.2 Inflation Forecast**

Envestra’s original submission proposed an inflation forecast of 2.57% per annum. In section 5.5.6 of the Draft Decision the AER calculated the inflation forecast to be 2.52% per annum. Envestra accepts the AER inflation forecast of 2.52% per annum for use in the Final Decision.

**9.2 Gearing Ratio**

For the original Access Arrangement submission Envestra considered that the efficient level of gearing should be in the range of 40% to 80%. The AER considers that gearing of 60% is appropriate for the benchmark efficient gas distribution business. Envestra accepts the AER’s preferred gearing level of 60% for use in the Final Decision.

**9.3 AER Recent Regulated Asset Sales Analysis**

The AER used the recent purchase of Country Energy’s NSW gas network by Envestra as a recent example of regulated energy networks being purchased at premiums to RAB. The AER used information contained in Envestra’s ASX announcement dated 26 October 2010 to incorrectly conclude that:

*Envestra purchased the Wagga Wagga gas network at a 25 per cent premium to the 2010 RAB and 19 per cent premium to the 2011 RAB.*

The purchase price of $107 million is not materially different to the Wagga Wagga gas networks RAB of $60.8 million at 31 October 2010 plus Non-regulated book value of the assets of $44.4 million ($105.2 million). Furthermore, two other key points were made in the Envestra ASX announcement: (i) the business was acquired using 61% debt and (ii) the discount rate used in the valuation was consistent with the rate of return submitted for the South Australian and Queensland Access Arrangement review in October 2010. These facts do not support the AERs observation that regulated cost of capital has been in excess of the actual cost of capital as the purchase price and capital structure were in line with the regulatory benchmarks; and the discount rate was consistent with that proposed in our October Revision.]

The AER summarised regulated asset sales data between 1999-2006. However, no adjustments were made to account for non-regulated revenues and/or assets of the businesses listed which could be driving at least a portion of the perceived RAB premium. Furthermore,, all of these asset sales / purchases occurred prior to the GFC when debt market liquidity and refinancing risk were significantly lower and they all occurred in a period where the regulated returns to equity were significantly higher than those being determined by the AER currently. The absence of any material premium to asset value in the Envestra acquisition of the Wagga Wagga networks shows quite clearly how changes in regulatory settings and the capital markets since 2006 have affected investors behaviour.

**9.4 Cost of Equity from Brokers Reports**

The AER questioned the relevance of equity broker research reports in testing the overall reasonableness of the AER’s return on equity. SFG has responded to the issues raised by the AER in its report titled *The required return on equity commensurate with prevailing conditions in the market for funds: Response to Draft Decision* dated 23 March 2011. The AER Draft Decision and SFG responses are summarised in the table below.

|  |  |
| --- | --- |
| Draft Decision Conclusion | SFG Response |
| SFG analysis should be afforded no weight as it relies on equity analyst price forecasts, which are unreliable and potentially biased. | SFG report does not rely on price forecasts; only uses dividend yields. SFG report uses the same conservative approach to price forecasts as the Draft Decision uses in producing “the most appropriate return on equity that can be derived from analyst reports. |
| Stapled security structure of comparable firms means that equity analyst forecasts should be adjusted by halving the forecasted dividend.  | No analyst for any of the comparable firms has forecasted any decline in dividends. The annual reports for the comparable firms state the objective of dividend increases and the means by which that will be delivered. No evidence of any expectation of any comparable firm slashing future dividends. |
| The firms that are analysed are not perfectly comparable to the benchmark firm. | The set of firms used is the same set of comparables that the AER uses to estimate beta, gearing , and credit rating. |
| Updated research reports should be used. | Agreed. The latest available data should always be used to estimate parameters. Updated estimates do not change the conclusions from our previous report. |

**9.5 Original Cost of Equity Submission**

In the Draft Decision the AER did not accept the cost of equity proposed by Envestra. One of the reasons given was that they interpreted Envestra’s October 2010 submission as using multiple models/methods, rather that just the CAPM, and this multiple model approach was not a ‘well accepted financial model’ as required by NGR 87.[[1]](#footnote-1)

Envestra does not believe the AER has correctly interpreted its approach to estimating the cost of equity. Envestra has used the CAPM to estimate the cost of equity. Envestra cross-checked the CAPM input parameters and overall cost of equity with alternative asset pricing models to ascertain the appropriateness of the cost of equity generated by use of the CAPM for use in accordance with Rule 87. *[[2]](#footnote-2)*  This is different to the AER approach of attempting to estimate CAPM parameters accurately and then assuming the outturn cost of equity is compliant with the NGR. Data and statistical issues with the AERs preferred equity beta and MRP estimate plus the low-beta bias of the CAPM call into question whether the AERs cost of equity does satisfy the rate of return requirements of the NGR. Envestra is of the view that multi-model cross check of the CAPM cost of equity significantly reduces any bias and/or anomalies that may arise in the AERs application of the CAPM.

1. SA Draft Decision, page 65 [↑](#footnote-ref-1)
2. Envestra, South Australian Access Arrangement Information, p 135-136 and Envestra, South Australian Access Arrangement Information, p 135-136 [↑](#footnote-ref-2)