

25 September 2018

Mr Warwick Anderson  
General Manager  
Australian Energy Regulator  
GPO Box 520  
Melbourne, Vic 3001

Dear Mr Anderson

## **Review of rate of return guideline – draft decision**

Evoenergy welcomes the opportunity to provide a submission on the Australian Energy Regulator's (AER's) draft decision for the 2018 rate of return guideline (2018 Guideline).

Evoenergy has serious concerns about the review process and outcomes proposed in the draft decision. Rather than undertaking an incremental review of the 2013 rate of return guideline (2013 Guideline), the AER's draft decision proposes a significantly different approach, particularly in relation to the return on equity and imputation credits. In Evoenergy's view, this is inconsistent with the decisions of the Australian Competition Tribunal<sup>1</sup> (Tribunal) and Federal Court.<sup>2</sup> In addition, Evoenergy considers the AER's draft decision does not properly reflect market evidence commensurate with prevailing market conditions and does not reflect a balanced, evidence-based and consistent approach. Consequently, the draft decision is inconsistent with the National Electricity Objective (NEO) and National Gas Objective (NGO) and undermines the principles of stability and predictability.

This submission provides Evoenergy's high level views on key issues including:

- The AER's approach to the review, which is inconsistent with the decisions of the Tribunal and Federal Court and inconsistent with its own stated approach;
- The AER's draft decision on the return on equity, which in Evoenergy's view fails to reflect the relevant evidence and results in estimates for equity beta and the market risk premium (MRP) which do not contribute to the achievement of the NEO and NGO;

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<sup>1</sup> Australian Competition Tribunal 2016, Application by ActewAGL Distribution [2016] ACompT 4, Application by Jemena Gas Networks (NSW) Ltd [2016] ACompT 5, Application by SA Power Networks [2016] ACompT 11, Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1, Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy [2016] ACompT 2, Applications by Public Interest Advocacy Centre Ltd and Essential Energy [2016] ACompT 3, Australian Competition Tribunal 2017, Application by ActewAGL Distribution [2017] ACompT 2

<sup>2</sup> Federal Court of Australia 2017, Australian Energy Regulator v Australian Competition Tribunal (No 2) [2017] FCAFC 79, Federal Court of Australia 2018, SA Power Networks v Australian competition Tribunal (No 2) [2018] FCAFC 3



- The AER's draft decision on imputation credits, which fails to reflect the relevant evidence; and
- The review process itself, including the Independent Review Panel, which has not achieved its main purpose of promoting stakeholder confidence<sup>3</sup>.

Evoenergy supports the more detailed submission prepared by Energy Networks Australia (ENA)<sup>4</sup> and this submission should be read together with the ENA submission.

### Approach to the review

Evoenergy has consistently advocated that the rate of return should reflect the decisions of the Tribunal and Federal Court.<sup>5</sup> The approach to estimating the rate of return and imputation credits has been the subject of several appeals that involved comprehensive reviews from both a merits and judicial review perspective. The resulting appeal decisions are therefore important in providing guidance on the rate of return approach that should be adopted going forward. Indeed, the implications of the appeal outcomes for determining the rate of return were the basis for the AER's request for a rule change to extend the deadline for the current rate of return review by two years to December 2018<sup>6</sup>.

In Evoenergy's view, the review of the rate of return guideline should reflect the following key decisions made by the Tribunal and Federal Court, which Evoenergy has adopted in both its proposal for the remittal of the 2014-19 determination and its proposal for the 2019-24 regulatory control period:

- For the return on equity, the Tribunal found no error in relation to the AER's 2013 Guideline methodology or estimate. Significantly, the Tribunal's finding of no error is premised on the Tribunal's acceptance of the existence of low-beta bias and, further, that low-beta bias is exacerbated in the prevailing conditions of low government bond rates and a high MRP.<sup>7</sup> On this basis, Evoenergy adopted the 2013 Guideline methodology for estimating the return on equity, including selection of point estimates for equity beta based on consideration of overseas estimates and the theoretical underpinnings of the Black CAPM and determining the range for the MRP with regard to historical excess returns, dividend growth model (DGM) estimates, survey evidence and conditioning variables as well as consideration of recent regulatory decisions among Australian regulators.
- On imputation credits, while the Tribunal (2016) found error in the AER's utilisation approach to estimating gamma, this decision was subsequently reversed in the

<sup>3</sup> The AER states that "The main purposes of the Independent Panel process is to give the AER the benefit of an independent review, and to promote confidence amongst stakeholders that our findings on rate of return issues are robust and have been tested." See <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-rate-of-return-guideline/draft-decision#step-56645>.

<sup>4</sup> ENA 2018, AER Review of the Rate of Return Guideline, Response to the Draft Guideline, September.

<sup>5</sup> Evoenergy 2018, Regulatory Proposal 2019-24, Attachment 8: Rate of return, imputation credits and forecast inflation, p. 8-1, 8-4 to 8-18, 8-23 to 8-24 and Evoenergy 2018, Review of rate of return guideline evidence sessions, submission to the AER, p.1

<sup>6</sup> AEMC 2016, Rule Determination National Electricity Amendment (Rate of Return Guidelines Review) Rule 2016, p.13-16

<sup>7</sup> Australian Competition Tribunal 2016, as explained in Australian Competition Tribunal 2016d at paragraphs 731, 749-50 and 779.



Federal Court (2017) decision and the AER's approach has since been accepted by the Tribunal (2017). Evoenergy therefore accepted the outcome of the Federal Court decision and adopted the AER's preferred value for gamma of 0.4 in its 2014-19 remittal and 2019-24 regulatory proposals.

Given that the Tribunal and Federal Court decisions endorsed the AER's 2013 Guideline methodology for the return on equity and imputation credits based on an assessment against the NEO and NER, it is Evoenergy's view that no change should be made to the 2013 Guideline approach without clear evidence to support such a change. This incremental approach to reviewing the 2013 Guideline is consistent with the approach the AER stated it would take to the review<sup>8</sup> and which was endorsed during the expert sessions<sup>9</sup>.

There have been no significant changes to finance theory since the 2013 Guideline that warrant a change to the 2013 Guideline methodology, which was reviewed and accepted by the Tribunal and Federal Court. Consequently, Evoenergy anticipated that an incremental guideline review would involve updating the value of the rate of return parameters to reflect the direction of market evidence since the 2013 Guideline and removing the discretion associated with the implementation of the 2013 Guideline methodology.

Instead, the AER's draft decision involves abandoning the foundation model approach for estimation of the return on equity contained in the 2013 Guideline by removing the role of the Black CAPM and DGMs. In addition, while all market evidence suggests an increase in the return on equity parameters, the AER has adopted lower values.

### Return on equity

The overriding objective of the guideline review is to provide an allowed rate of return which contributes to the achievement of the NEO and NGO to the greatest degree. Evoenergy agrees with the AER that this is achieved by setting the allowed return equal to the best estimate of the required return, based on market data and commensurate with the prevailing conditions in the market.<sup>10</sup> In Evoenergy's view, however, the AER's draft decision for the return on equity fails to do this.

The AER's draft decision on equity beta, which reduces the parameter value from 0.7 under the 2013 Guideline to 0.6:

- ignores available evidence on domestic firms since the 2013 Guideline which supports an increase in beta estimates;
- ignores international evidence which clearly supports an equity beta above 0.6;
- ignores compelling market evidence of low-beta bias;
- relies disproportionately on outdated data from firms that no longer exist; and

<sup>8</sup> AER 2017, Issues Paper, Review of Rate of Return Guideline, October, p.8

<sup>9</sup> Joint Experts' Report 2018, Proposition 2.12, p. 18

<sup>10</sup> AER 2018, Draft Rate of Return Guideline: Explanatory Statement, , p.29, 32, 77



- removes, without any evidence or explanation, the role of the Black CAPM to inform the selection of the equity beta point estimate.<sup>11</sup>

The AER's draft decision on the MRP, which reduces the parameter value from 6.5 per cent in the 2013 Guideline to 6.0 per cent:

- reflects the bottom of the range based on the AER's historical excess returns evidence using arithmetic means, despite evidence which supports a higher point estimate;
- relies on consideration of geometric means, which is at odds with an objective assessment of the evidence presented;
- ignores DGM estimates, despite no valid evidence to support the change in approach from the 2013 Guideline and despite the key benefit of DGMs in that they provide an estimate of the MRP that is commensurate with prevailing market conditions;
- ignores survey evidence that the MRP in the prevailing market conditions is materially above 6.0 per cent; and
- ignores any reasonable objective review of the evidence from other regulators which strongly supports an MRP above 6 per cent in prevailing market conditions.<sup>12</sup>

The resulting equity risk premium of 3.6 per cent in the AER's draft decision fails all reasonable cross-checks including an assessment against:

- the Wright approach, with a range of 4.4 to 5.9 per cent;
- other regulatory decisions, which all materially exceed 3.6 per cent;
- broker estimates, which range from 4.1 to 4.9 per cent with no adjustment for imputation credits (and hence would be even higher with such an adjustment); and
- independent expert valuation reports, which support a range from 4.4 to 4.6 per cent with no adjustment for imputation credits.<sup>13</sup>

In Evoenergy's view, proper consideration of the evidence could not result in the best possible estimate of equity beta being 0.6 or the best possible estimate of the MRP being 6.0 per cent. Based on market data, commensurate with prevailing market conditions, an incremental review could only result in either no change to the 2013 Guideline values or an increase in these values.

Evoenergy supports the ENA's assessment that an objective and balanced assessment of the relevant evidence supports an equity beta of at least 0.7 and an MRP of at least 6.5 per cent in the prevailing market conditions.

<sup>11</sup> These issues are discussed in detail in the equity beta section of the ENA submission.

<sup>12</sup> These issues are discussed in detail in the MRP section of the ENA submission.

<sup>13</sup> These issues are discussed in detail in return on equity cross-checks section of the ENA submission.



## Imputation credits

Consistent with the most recent Tribunal and Federal Court decisions, Evoenergy accepts the AER's utilisation interpretation of gamma. In the context of an incremental review, Evoenergy would expect the utilisation estimate of gamma to involve pairing the AER's preferred estimate of the distribution rate for listed equity (the Lally 83% estimate) with the AER's preferred estimate of the utilisation rate for listed equity (the equity ownership mid-point estimate of 47%), producing a gamma of 0.39.

However, the AER's draft decision adopts the distribution rate for the top 20 ASX-listed firms, despite the evidence providing no support for this over 2013 Guideline approach. The ENA submission identifies a number of problems with the 20 firm approach, including:

- the 20 firms are not appropriate comparators for the benchmark efficient entity;
- the estimates are derived from franking account balance (FAB) data, which is known to be unreliable due to the 'dynamic nature of the imputation system.'; and
- the 20 firms approach assumes that all reductions in the FAB relate to credits being distributed to shareholders, however material reductions occur for other reasons. Consequently, this approach can only be used to estimate an upper bound and not a point estimate for the distribution rate and thus gamma<sup>14</sup>.

The ENA has previously provided evidence to demonstrate that there are no material concerns with the ATO estimates of credits created or credits redeemed, with the result that the estimate of gamma calculated directly from ATO statistics is reliable. The ATO tax statistics approach produces an estimate for gamma of 0.34<sup>15</sup>. Therefore, if the AER were to alter its estimate of gamma from the prevailing value of 0.4, the evidence supports a range of 0.34 (based on the ATO tax statistics approach) to 0.39 (based on the equity ownership approach).

## Concerns regarding the review process

Evoenergy shares the concerns raised in the ENA submission around the review process to date, including the Independent Review Panel (Panel) process<sup>16</sup>. The Panel was provided very little time to consider a complex range of issues, which have been the subject of extensive debate over a lengthy period of time. Based on the Panel report, it is clear that the Panel has not been able to consider all relevant documentation, particularly the arguments and evidence submitted by the distribution businesses and the ENA. The Panel report gives limited consideration to the key issues in contention, which are critical in determining the overall rate of return and it does not form a view on whether the AER's proposed rate of return will, or is likely to, produce an allowed return that contributes to the NEO and NGO to the greatest degree<sup>17</sup>. As a result, it is Evoenergy's view that the Panel report does not

<sup>14</sup> These issues are discussed in detail in the imputation credits section of the ENA submission.

<sup>15</sup> See imputation credits section of the ENA submission.

<sup>16</sup> These concerns are discussed in detail in the review process section of the ENA submission.

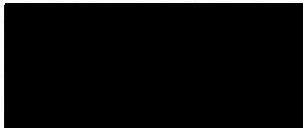
<sup>17</sup> While this is the objective of the Guideline process, the Panel was instead asked to consider whether the draft guideline is supported by sound reasoning based on the available information such that it is capable of promoting the achievement of the NEO and NGO.



achieve its main purpose of promoting confidence amongst stakeholders that the AER's findings on rate of return issues are robust and have been tested.

Evoenergy looks forward to a final decision on the rate of return that promotes outcomes consistent with the long-term interests of consumers. If you wish to discuss any aspect of our response, please do not hesitate to contact Alexis Hardin, Manager Regulatory Finance and Strategy on [REDACTED] or [REDACTED]

Yours sincerely



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