Jemena Gas Networks (NSW) Ltd

Review of submissions on JGN's revised AA

Attachment A - Review of EMRF comments on the return on equity

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GLOSSARY

AER	Australian Energy Regulator
DDM	Dividend Discount Model
DRP	Debt Risk Premium
EMRF	Energy Market Reform Forum
ERP	Equity Risk Premium
FFM	French-French Three-Factor Model
JGN	Jemena Gas Networks
Guideline	Rate of Return Guideline
SL-CAPM	Sharpe-Lintner Capital Asset Pricing Model

1.   SUMMARY

1. The Energy Market Reform Forum (**EMRF**) supports the Australian Energy Regulator's (**AER**'s) approach to determining the return on equity.[1]   The EMRF also has material concerns with the approach proposed by Jemena Gas Networks (**JGN**) and considers there is no basis to depart from the AER's rate of return guideline (**guideline**).

2. We consider these concerns do not hold and there are good reasons to depart from the guideline—which we explain in JGN's initial proposal, revised proposal, and submission on the AER draft decision for JGN.

Our approach is not unnecessarily complex

3. The EMRF considers that we have presented an unnecessarily complex approach to estimating the return on equity that leads to that return being overstated.   The EMRF advocates for what is sees as a more common sense approach—whereby market-based evidence is placed at the forefront of the determination over what the EMRF considers to be a theoretical approach of JGN.

4. However, the EMRF falls short of showing how a more applied approach can be implemented to arrive at the return on equity.   It simply asserts that the return on equity put forward by JGN is clearly too high in light of actual market outcomes, but without referencing the relationship between those market outcomes and the return on equity.

5. Our approach considers relevant evidence on its merits and weights this together, transparently, to arrive at an estimate of the return on equity.

Our approach considers both theory and market evidence

6. The EMRF also characterises our approach as theoretical—which is also not true.   We rely extensively on analysis of market prices and returns to reach decisions based upon empirical evidence, not theories.

7. Our approach combines both theory and market evidence, recognising the strengths and weaknesses of each. Most importantly, we recognise the empirical failings of the Sharpe-Lintner capital asset pricing model (**SL-CAPM**) by augmenting return on equity estimates from this model with those from others.

Our approach is transparent and consistent

8. Finally, the EMRF also characterises our approach of using weights to reach decisions as non-transparent and inconsistent.   This is also false.

9. As we document in section 2.2, the AER uses the same underlying approaches to reach decisions on the return on equity, but with less clarity on how information is used.   The weight allocated to different pieces of information can vary amongst different experts and over time—but that variation merely reflects the reality that the implications of different information is not perfectly clear.

10. Reaching conclusions simply by writing down the final answer does not make the approach more transparent and consistent when compared to an alternative approach that writes down *how* this answer is derived directly from relevant evidence.

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[1]   EMRF, *Submission on JGN draft decision*, 30 March 2015, section 4.

2. REVIEW OF EMRF ARGUMENTS

2.1 THE ROLE OF MARKET INDICATORS

2.1.1 INTRODUCTION

11. The EMRF puts forward an overall theme that there are clear market indicators (or outcomes) that suggest the AER allowed rate of return is more than fair. These indicators include acquisition multiples compared to the regulated asset base,[2] and a comparison of the equity risk premium (**ERP**) compared to the debt risk premium (**DRP**).[3] The EMRF considers that JGN has taken an overly theoretical approach to its analysis that leads to an outcome that just does not make sense in light of market data.[4]

12. This proposition is not true. At its heart is the contention that one can easily interpret some market based evidence to arrive at sensible rate of return estimates without reference to the empirical research and extensive analysis of market-based information relied upon by JGN. However, neither the EMRF, nor the AER, has actually used the information referred to by JGN to make an estimate of the return on equity.

13. If anything, JGN's approach better reflects market evidence than the AER's because we use this information directly to estimate the return on equity. The market indicators identified by the EMRF do not change this.

2.1.2 RELEVANCE OF MARKET INDICATORS

2.1.2.1 Acquisition multiples

14. The AER ruled out using acquisition multiples to estimate the return on equity because it could not determine a method to convert this information into rate of return estimates.[5] The challenge is distinguishing between the component of the acquisition price that relates purely to the expected cash flows of the underlying asset, and the remainder of the acquisition price that reflects its unique value to the acquiring firm. Another challenge is determining how much to rely on acquisition prices over the share prices that we observe in the market every day.

15. The AER also ruled out using share prices of listed energy networks to estimate the return on equity because it considered the resulting estimates were implausible high.[6] This conclusion was based on the AER's own dividend discount model (**DDM**) analysis. JGN submitted return on equity estimates based upon analysis of historical equity prices for listed energy networks from more than a decade. But the AER rejected this more detailed analysis.[7]

16. So what the EMRF has put forward—that acquisition multiples clearly indicate the conservatism in the AER's rate of return estimate—is simply not true. Neither the EMRF nor the AER has estimated what the fair rate of return estimate should be based upon this data because making the estimate is more difficult than suggested in the EMRF's submission. Without these estimates it is not possible to determine what is fair or not from these multiples.

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2   EMRF, *Submission on JGN draft decision*, 30 March 2015, p. 68.

3   EMRF, *Submission on JGN draft decision*, 30 March 2015, p. 65.

4   EMRF, *Submission on JGN draft decision*, 30 March 2015, p. 68.

5   AER, *JGN Draft Determination, Attachment 3*, November 2014, pp. 68, 73 and 74.

6   AER, *Rate of Return Guideline, Appendix E.3*, December 2013, p. 122.

7   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 66, and 228 to 231.

17. Further, even if it was possible to easily convert acquisition multiples into a rate of return estimate, then it would also be possible to do the same thing with respect to price multiples of the same companies using closing prices observed every day. Yet this has also been discounted. It would be inconsistent to use acquisition multiples to estimate the return on equity while ignoring price multiples.

2.1.2.2 The debt risk premium

18. The relationship between ERP and the debt risk premium (**DRP**), in effect, relates to an estimate of the MRP because both the DRP and MRP are independent of the particular features of an energy network. Although the DRP reflects the risk of a benchmark efficient energy network *in theory*, it is estimated with reference to all debt with a benchmark credit rating *in practice*.

19. Both JGN and the AER agree that the market return today can be estimated using the DDM, but disagree over the best way to estimate those dividends.[8] The AER relies upon current share prices, dividend forecasts and an assumed long-term growth rate to estimate the *current* expected return on the market.[9] JGN adopts the same idea in estimating the market return today, but estimates the stream of dividends in a different manner to the AER by using a large sample of analyst earnings forecasts.

20. The EMRF points out that current estimates of the DRP clearly suggest that the AER's allowed ERP of 4.55% (0.7 × 6.5% = 4.55%) is at least reasonable to JGN. The EMRF states that the allowed ERP of 4.55% is 2.17% more than the DRP.[10] But the EMRF does not estimate what the MRP should be given an estimate of the DRP—it simply stats that the ERP allowed by JGN is more than fair. The AER also does not estimate the MRP using the DRP, but considers the DRP to be informative in selecting the MRP from within a range.[11]

21. As with acquisition multiples, the EMRF has proposed that one can estimate the return on equity with greater clarity and transparency by simply examining market-based information—in this case using the DRP. Yet neither the EMRF, nor the AER, has actually estimated the return on equity using the DRP.

22. Further, neither the EMRF, nor the AER, has put forward a way to estimate dividends or long-term growth as a function of the DRP. The AER's estimates of the expected market return have not moved in a one for one relationship with corporate bond yields, and the AER's estimate of the MRP based upon dividend yields and long-term growth was 7.4% in the draft decision.[12] Dividend yields have been around 4.0% to 5.5% for around five years, during which time government bond yields have fallen.[13]

23. Yet the EMRF contends that it is simply obvious that the market return estimates of JGN are too high. Put directly, the EMRF writes that:[14]

> *JGN provides no satisfactory answer to the question of why the ERP should have risen in the period between May 2014 and February 2015 and why it should sit at a level that is well above historical observations*

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[8] The DDM posits that today's expected market return is the present value of expected future dividends.

[9] AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 215.

[10] EMRF, *Submission on JGN draft decision*, 30 March 2015, pp. 65 to 66.

[11] AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 203.

[12] AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 200.

[13] AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 202.

[14] EMRF, *Submission on JGN draft decision*, 30 March 2015, p. 64.

24. and in a footnote states that:[15]

> [t]he EMRF would look for an explanation in terms of underlying trends in the real world.

25. The answer (as to why the ERP has risen) is that dividend yields have not fallen as far as corporate bond yields. Asserting that JGN's estimates of the MRP are a mere artefact of econometric models that do not rely upon real world data, is not true. Our MRP estimate relies on a mix of current and historical market-data, much like the AER's estimate does.

2.1.3   A MARKET-BASED APPROACH

26. Having expressed a preference for a more simple and market-based approach to estimating the return on equity, the EMRF endorses the approach taken by the AER. We consider this preference is misguided.

27. The AER approach:

- uses the SL-CAPM to estimate the return on equity[16]

- estimates the MRP primarily on the basis of historical excess returns,[17] and

- estimates equity beta on the basis of historical returns for a small sample of listed networks.[18]

28. In no way does this approach reflect what the EMRF sees as clear market-based evidence on the rate of return. The SL-CAPM is a theoretical model developed over 50 years ago. Applying that model using old or unreliable sample data does not make it any more market-based.

29. In contrast our approach incorporates reliable market evidence that:

- stocks earn higher returns than predicted by the SL-CAPM

- stocks with high book-to-market ratios earn higher returns than predicted by the Sharpe and Lintner, and

- share prices of listed energy networks suggest a rate of return that is higher than predicted by the SL-CAPM.

30. The EMRF characterises JGN's approach as overly theoretical.[19] But what we have done is examine the market information over an extended time period and demonstrated that the theoretical estimate of the return on equity from the SL-CAPM does not match the market data. Suggesting that it is JGN's approach that is unduly theoretical is simply not correct.

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[15]   EMRF, *Submission on JGN draft decision*, 30 March 2015, p. 64.

[16]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 27.

[17]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 194.

[18]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 81.

[19]   EMRF, *Submission on JGN draft decision*, 30 March 2015, p. 68.

2.2   TRANSPARENCY, CONSISTENCY AND THE EXERCISE OF JUDGMENT

2.2.1   INTRODUCTION

31. The EMRF argues that JGN's multi-model approach is 'open to manipulation and displays a lack of transparency and consistency'.[20] The reality is that—in comparison to the approach of the AER that has been endorsed by the EMRF—the opposite is true.

32. We are transparent about the weights given to different return on equity models and to different parameter estimates used to populate those models. The AER approach is not transparent because it uses a small subset of information to derive ranges for parameter estimates, and the AER simply states that other information is considered in reaching its conclusions.

33. To explain this issue we need to separately consider two questions:

1. **What is the best estimate of the return on equity for the typical firm in the market**—so, what is the expected market return and the MRP?

2. **What is the relative risk of a benchmark efficient energy network compared to the typical firm in the market**—so, what is the beta in the Sharpe-Lintner CAPM or the implied beta resulting from the use of a number of models?

34. The 'multi-model approach' proposed by JGN only applies to the second question listed above. It does not apply to an MRP estimate.

2.2.2   MARKET RISK PREMIUM

2.2.2.1 JGN's approach

35. With respect to estimating the MRP, we should be clear about what we propose. We determined MRP estimates from historical excess returns, historical real returns, share prices and analyst expectations for earnings and dividends, and surveys.

36. In an ideal world we would have a very precise estimate of the MRP that reflects equity prices at a point in time. But we recognise that MRP estimates are imprecise by giving explicit consideration to information from historical returns and surveys.

37. After considering the merits of each piece of evidence, we estimate the MRP as:

$$MRP = 0.5 \times MRP \text{ implied by share prices and expectations for earnings and dividend}$$

$$+ 0.2 \times MRP \text{ implied by historical excess returns}$$

$$+ 0.2 \times MRP \text{ implied by historical real returns}$$

$$+ 0.1 \times MRP \text{ implied by survey evidence}$$

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[20]   EMRF, *Submission on JGN draft decision*, 30 March 2015, p. 55 to 56.

2.2.2.2 The AER's approach

38. The AER agrees that each of the four pieces of information is relevant evidence for reaching an overall conclusion on the return on equity. But the AER uses all four in different ways.

39. Specifically, the AER adopts a four step process:

- **Step one.** The AER estimates a range for the MRP based upon historical excess returns. This range is 5.1% to 6.5%.[21]

- **Step two.** The AER augments the range based upon the AER's analysis of share prices and expectations for earnings and dividends. The upper bound estimate of the MRP from this approach is 7.8% so the MRP range becomes 5.1% to 7.8%.[22] The AER makes it clear that, in the view of the AER, historical excess returns are the most reliable information for estimating the MRP.[23] On the basis of these two pieces of information the AER estimates a MRP of 6.5%.[24]

- **Step three.** The AER considers survey evidence and, without specifying any particular weight on survey evidence, concludes that the survey evidence in consistent with the AER's 6.5% estimate of the MRP.[25] The same comment applies to other information considered by the AER in estimating the MRP. The other information is only used to determine whether it is inconsistent with the AER's initial estimate of the MRP. There is no conclusion on what the MRP would be with, or without, consideration of other information.

- **Step four.** The AER considers historical real returns only with respect to the overall return on equity estimate. The AER constructs a wide range for the return on equity resulting from a combination of a range for beta and a range for the MRP. The range is so wide (2.6% to 6.5%)[26] that it is implausible that it would ever be used to alter the AER's estimate of the ERP. So historical real returns effectively carry no weight on the AER's decision-making.

40. We consider this approach underweights key evidence, such as forward-looking estimates from the DDP and historical real realised returns on the market.

2.2.2.3 Our approach is more transparent, not less, than the AER's

41. JGN and the AER consider the same four types of information in reaching a conclusion on the return on equity—but the approach to arriving at a conclusion on the MRP differs.

42. In short, two approaches are:

1. **JGN approach**—write down a set of weights determined using judgement and compute a weighted average MRP

2. **AER approach**—do not write down a set of weights and simply use judgement to reach a conclusion.

43. Everyone reading our proposal knows how much relative weight (or consideration) was given to each type of information in reaching a conclusion. Conversely, no one reading the AER draft decision can determine the relative consideration given to these types in reaching its conclusion. Our concern is that the EMRF is not

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[21]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 77.

[22]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 77.

[23]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 194.

[24]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 79.

[25]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 77.

[26]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 32.

making a fair comparison of the two approaches when submitting that ours is less transparent, subject to greater manipulation and is less consistent than the AER's.

44. We do not dispute that the judgement is required in selecting the weights. Different experts may put forward different weights for different pieces of information at one point in time and these weights may change over time.

45. But the AER approach also applies judgement in reaching a conclusion on the MRP. The key difference is that at no stage can we easily determine how much weight was placed on different types of information under the AER approach.

46. The EMRF contends that JGN can manipulate the process by writing down a set of weights. This is not true. It would be easier to manipulate an outcome by using an unspecified amount of judgement, as the AER's approach does. Making the process more transparent helps reduce the risk of manipulation—we support this and are concerned that the AER's approach does not.

47. The EMRF also contends that merely changing weights, or having experts differ on weights, means there is an inconsistency in the approach. This is also not true. Weights can change over time—the key is to ensure any change is transparent and explained. Simply writing down a conclusion (or change in conclusion) does not improve consistency because a stakeholder cannot necessarily know what, if any, change there was to how different pieces of information were considered.

2.2.3   RELATIVE RISK OF A BENCHMARK EFFICIENT ENERGY NETWORK

48. JGN's approach to estimating the return on equity clearly distinguishes between the relative risk of the benchmark energy network and the typical listed firm. Our approach combines four estimates of return on equity a listed energy network: one from each of:

    1. the SL-CAPM

    2. the Black CAPM

    3. the Fama-French three-factor model (**FFM**), and

    4. share prices and analyst expectations of earnings and dividends (using the DDM).

49. The AER agrees that information relating to the SL-CAPM and the Black CAPM is relevant for estimating the return on equity.[27] The AER also agrees that using share prices and analyst expectations from earnings and dividends would be relevant if there was a reliable way to make the estimate of the return on equity—but does not use this approach because it found no way to make reliable estimates using this information.[28] The AER does not agree with using the FFM to estimate return on equity.[29]

50. Putting these differences to one side, there are also material differences in how the JGN and AER approaches combine relevant evidence.

2.2.3.1 JGN's approach

51. As with estimating the MRP, in an ideal world we would have a very precise estimate of the return on equity that reflects equity prices at a point in time. But JGN recognises the challenges this poses and so gives most weight

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[27]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 28.

[28]   AER Rate of Return Guideline, Appendix E.3, p. 119 to 120.

[29]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 46.

in its conclusions to estimates of the return on equity based upon the historical estimates of relationship between factor returns and stock returns.

52. After considering the merits of each piece of evidence, we estimate the return on equity as:

Return on equity = 0.25 × return on equity implied by the SL-CAPM

+ 0.25 × return on equity implied by the Black CAPM

+ 0.25 × return on equity implied by the FFM

+ 0.25 × return on equity implied by the DDM.

2.2.3.2 The AER's approach

53. In contrast, the AER adopts a two-step process to combine what it considers relevant evidence:

- **Step one.** The AER adopts the SL-CAPM as its single model to estimating the return on equity.[30] The FFM and the return on equity implied by share prices and expectations for earnings and dividends (i.e. the DDM) are excluded from consideration.

- **Step two.** The AER then recognises that the return on equity should recognise what the AER terms the 'theoretical underpinnings' of the Black CAPM.[31] This means that the idea of the Black CAPM is used by the AER to select a beta estimate for use in the SL-CAPM. Importantly, the AER does not specify what the return on equity would be with, or without, considering the idea of the Black CAPM.

54. So we know that the AER relies upon two of the four estimates listed in paragraph 48—giving zero weight to the latter two approaches—but leaves the relative weights applied to the SL-CAPM and the Black CAPM unspecified.

2.2.3.3 Our approach is more transparent, not less, than the AER's

55. As with the MRP, the EMRF is not fairly comparing the JGN and AER approaches. It is simply not true that:

- our approach to estimating the return on equity is less transparent than the AER's, not

- applying weights leaves the process open to manipulation and lacks consistency.

56. The EMRF points out that JGN previously applied a 12.5% weight to the SL-CAPM (compared to 25.0% now) and a weight of 37.5% to the FFM (compared to 25.0% now).[32] But this change in weights does not mean that JGN is attempting to manipulate the outcome—the very disclosure of the weights acts a barrier to manipulation.

57. On the one hand, the AER has excluded using the FFM and placed primary reliance on the SL-CAPM. And on the other, JGN places positive weight on both models. The EMRF is concerned that changing weights implies manipulation and consistency. But this misses the key point—that placing primary reliance on the SL-CAPM understates the return on equity.

58. By applying equal weights to the four return on equity estimates, we are simply recognising that the return on equity estimates from the SL-CAPM appear low. This is not surprising given that we know from decades of

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[30]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 46.

[31]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 265.

[32]   EMRF, *Submission on JGN draft decision*, 30 March 2015, p. 74.

returns in different markets that actual stock returns on low beta stocks are higher than implied by the SL-CAPM.

59. By moving to equal weights (from mixed weights), we are simplifying our approach. The fact that this move results in a lower return on equity estimate—by placing greater weight on the lower estimate—further highlights that we are not using this to manipulate the outcome in our favour.

2.3   CONSERVATISM

60. The EMRF also argues that the AER 'builds conservatism on conservatism' by selecting inputs at the upper end of ranges and does not account for the regulatory protections afforded to JGN.[33] We do not agree.

61. In addressing this point, we clarify three aspects of the AER draft decision.

2.3.1   PREVAILING COST OF FUNDS

62. First, the AER has made what it considers is an estimate of the prevailing cost of funds. The AER has not made an upwardly biased estimate of the rate of return in order to mitigate against a concern that the allowed return is too low. Further, the AER has made this decision with an understanding of the entire regulatory framework being faced by JGN.

63. So, while the EMRF may view the allowed return as too high, this is not the view of the AER.

2.3.2   USE OF RANGES

64. Second, selecting parameter estimates at the upper end of ranges is not a mechanism used by the AER to make a conservatively high estimate of the rate of return.

65. The reason the AER ends up selecting parameter estimates at the upper end of ranges is because the AER forms ranges with respect to one set of information, and then uses different information to select final parameter estimates from within those ranges. The ranges used by the AER have not been framed around a mid-point that is an unbiased estimate of the parameter.

66. This point can be explained with respect the ranges for beta and MRP used by the AER.

2.3.2.1 Beta range

67. The AER estimates beta from within a range of 0.4 to 0.7—formed entirely with respect to beta estimates for Australian-listed firms.[34] The AER's assumption is that beta is 0.7.[35] The range for beta estimates is formed by regressing stock returns on market returns. The AER then considers the Black CAPM and forms the view that if the Black CAPM is ignored, then the return on equity is likely to be understated. Having chosen to give some consideration to the Black CAPM—but without using this model directly—the AER adjusts its beta estimate.[36]

68. This is not making a conservative estimate of beta. This is simply using information to determine what is—in the AER's view—the right estimate of beta.

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[33]   EMRF, *Submission on JGN draft decision*, 30 March 2015, p. 70.

[34]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 30.

[35]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 30.

[36]   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 30.

69. The same comment applies to the AER's use of beta estimates for firms listed in markets other than Australia. The AER does not form a view on the beta estimate for these firms, nor does the AER specify what weight should be allocated to this evidence. Instead, the AER acknowledges that this information is relevant to its beta estimate and so uses this information to adjust its beta estimate.[37]

70. Again, this is not making a conservative estimate of beta. This is simply using information to determine what is—in the AER's view—the right estimate of beta.

2.3.2.2 MRP range

71. The AER estimates the MRP from within a range of 5.1% to 7.8%—reaching an assumption that the MRP is 6.5%.[38] The range of MRP estimates was formed with respect to historical average returns and market return estimates implied by share prices and analyst forecasts.[39] The AER then considers other information, including survey evidence, dividend yields, corporate bond spreads, and implied volatility, in reaching its conclusion.[40]

72. The AER's view is that historical excess returns imply an MRP estimate of 6.0%.[41] But the AER is also aware that the implied MRP from share prices and analyst forecasts is well above 6.0%—and so reaches a final MRP estimate of 6.5%.

73. The AER did not adopt the 6.5% to mitigate the risk of the allowed return being too low. The AER made what it considers to be an appropriate estimate of the MRP.

2.3.3   REGULATORY PROTECTIONS

74. Third, the EMRF asserts that the manner in which JGN is regulated largely mitigates the risks it faces. Moreover, the EMRF considers that the overall regulation of JGN is favourable to it and so it is inappropriate to be even more favourable to JGN in the allowed return.

75. Underpinning this view is the idea that regulation of a business necessarily reduces the risk of the business below a competitive market situation. The asset returns to an energy network have low risk because the asset is a large scale infrastructure project that generates an essential commodity—and this is why an energy network is able to finance its operations with 60% debt.

76. A network is regulated because it has monopoly characteristics. Rules operate to govern this regulation and a regulator (in this case the AER) applies those rules to replicate competitive market outcomes. These rules incentivise that network to operate efficiently and constrain opportunities to earn monopoly rents—this is the basic idea behind the actual rules that govern the economic regulation of JGN (i.e. the National Gas Rules).

77. There is nothing in this regulatory approach to suggest that the rules reduce the risk of the energy network compared to an unregulated situation. The rules constrain the energy network from decisions it would make in an unregulated situation—examples being the difference in views between JGN and the AER on appropriate capital expenditure and operating cost estimates. The EMRF considers that there are aspects of the regulatory framework that protect a network against competitive market outcomes. But the reality is that the regulatory framework is merely trying to replicate those competitive market outcomes and, in doing so, introduces regulatory risk of its own.

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37   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 30.

38   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 29.

39   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 29.

40   AER, *JGN Draft Determination, Attachment 3*, November 2014, pp. 201 to 205.

41   AER, *JGN Draft Determination, Attachment 3*, November 2014, p. 77.

78. What the EMRF sees as protection—the use of a trailing average return on debt, annual updating of the return on debt, and indexation of the asset base—[42] is an approximation of a normal situation in which the owner of a large, fixed asset renegotiates contractual terms every five years. The EMRF simply assumes that a set of terms that reflect the interest payments required on debt and allow returns on investment to be recovered over time—imply a lower rate of return than allowed by the AER.

79. This is not correct. The conservatism argument is merely an extension of the EMRF's overall claim that the allowed return is already generous to JGN, but without analysis of what is the fair return for what the EMRF views as protection. Without quantifying this return it is not possible to conclude that the AER's return on equity estimate is conservative or not.

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[42]   EMRF, *Submission on JGN draft decision*, 30 March 2015, p. 62.