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Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
Canberra ACT 2601

By email: rateofreturn@aer.gov.au

12 December 2017

Dear Warwick

Response to AER's Issues Paper on the Rate of Return Guideline

The Australian Energy Regulator (**AER**) has invited submissions to its Issues Paper on the Review of the Rate of Return Guideline. Jemena Limited (**Jemena**) welcomes this opportunity to provide its views on the way AER could undertake the review on various elements of the guideline.

Jemena supports the AER's approach to conducting an incremental review of the rate of return. There is a significant amount of water under the bridge on the rate of return, particularly in recent years, so a measured and targeted review is sensible.

Jemena has been involved with developing the Energy Network Australia (**ENA**) submission, as well as the submission of the Victorian Electricity Distribution Networks.

We have chosen to make an additional submission because we considered it worthwhile:

- sharing our customers perspectives on their energy supply experiences and preferences, as expressed to us directly, and how this has influenced our thinking;
- affirming Jemena's position of taking a principled approach to this review, and our commitment to working collaboratively with the AER through this process;
- exploring a further refinement to the AER's current approach which may not be expressed in other submissions to the review, including those mentioned above.

We look forward to working with the AER to develop a guideline that is capable of acceptance by all stakeholders, and promotes the long-term interests of consumers.

Context

Our starting point for this review has been to reflect on what our customers have been telling us about their energy supply priorities. Our customers have been telling us that:

- they are struggling with cost of living pressures and that energy bills are adding to this (particularly electricity bills);
- unlike many other major household expenses (like mortgages, rent, insurance, internet and groceries), energy bills can be highly unpredictable – "bill shock" is more prevalent relative to other household expenses;
- the energy market is extremely complex – customers have little understanding of what they are paying for in their bills, nor why energy prices have been increasing;
- customers expect the energy market to become even more complex, with the rise of new technology and concerns about the availability of gas in Australia;
- customers value the high level of reliability that our networks (Jemena Gas Networks and Jemena Electricity Networks) provide – our business customers, in particular, suffer material loss from unplanned outages; and
- many (if not most) customers would not accept a lower level of network reliability – a reduction in reliability is generally considered a step backward in an advanced economy like Australia.

Within this context, we have developed principles for the rate of return review that will guide our thinking and helps us collaborate with other stakeholders. These principles:

- reflect the service and price outcomes our customers expect, now and into the future
- all stakeholders might be able to support, recognising that broad stakeholder acceptability for the rate of return is desirable (as elaborated on by the ENA its submission).

The principles are –

1. *Stability* – approaches should be preferred where they promote a stable allowed rate of return across time, to promote stability in customer bills over time.
2. *Consistency* – approaches should be preferred where businesses on the same regulatory cycle receive the same allowed rate of return (unless there is a difference in business risks that needs to be accommodated)
3. *Accuracy* – networks should be compensated for the fair and reasonable cost of funding investment in the network to deliver the level of reliability that customers expect. An accurate estimate helps ensure that customers are paying no more than necessary to fund efficient investment in networks.
4. *Predictability* – the rate of return should not be a surprise to stakeholders at each individual network determination – there should be a high degree of

predictability in the ultimate "number" that would be delivered by the rate of return guideline, assessed at the time the guideline is finalised. A predictable estimate will help networks better explain, in advance, the future direction of network prices and reduce the overall complexity of bill components.

5. *Sustainability* – To the extent possible, the rate of return guideline should be resilient to exogenous shocks to minimise the likelihood of any re-openers and the need to change the rate of return guideline at future reviews. Our preference is that this review can promote more trusted and collaborative engagement among stakeholders and result in a sustainable outcome for future reviews.

Focus area - return on equity

Jemena does not intend to re-open the AER's preferred foundational model approach on the return on equity. This submission is focussed on incremental refinements to the parameter setting processes which we believe can deliver better outcomes for customers.

In measuring the return on equity network service providers (NSPs) are required to nominate a 20 business day averaging period for measuring the risk free rate. This means that:

- if two NSPs are servicing neighbouring areas, have the same review cycle but nominate different averaging periods, the risk free rate can be different (and potentially significantly different)—this is not congruent with the consistency principle

- because the averaging period is quite short, this can result in a "lottery-type" outcome for the allowed rate of return, which can therefore drive a similar outcome for customer bills over time—this is inconsistent with the stability and predictability

Also there is uncertainty regarding measurement of the equity risk premium (ERP). This is subject to AER discretion at each regulatory review, which makes it difficult for investors (and customers) to predict what allowed return on equity will be set by the AER.

Therefore we believe it is worth exploring refinements to the current framework which can further improve a stable, predictable and consistent allowed return on equity outcome for our customers and investors.

Our proposed alternative is targeted at what we see to be potential areas of improvement with the current return on equity methodology. This improvement is focussed on the stability, predictability and consistency of the return on equity.

A proposed alternative

Our proposed method has three key elements:

- a longer averaging period for the risk free rate in the return on equity (3 to 12 months)—we believe that a longer period will promote stability in the risk free rate estimate relative to a short period (of 20 business days);

- a common averaging period for all networks in the same jurisdiction, on the same regulatory cycle—we believe a common period will promote consistency in the return on equity estimate for neighbouring networks (and therefore consistency in bills for neighbouring customers where this makes sense); and

- fixing the ERP at the Guideline review—we believe this will promote stability, predictability and consistency, of the allowed rate of return, particularly if the proposal to lengthen the risk rate averaging period (and therefore further stabilise the risk free rate) is adopted.

Jemena has also reflected on further options to stabilise the return on equity estimate over time. An option that may further promote this objective would be to adopt a 10-year transition to a 10-year trailing average for the risk free rate.

Importantly, we emphasise that this would involve a 10-year transition similar to the AER's current approach to transition for the cost of debt. We recommend that a longer averaging period (3 to 12 months) would also be preferable under this option.

The key benefit of this approach is that it may further stabilise the risk free rate over the long-term. The Guideline would potentially be more sustainable over the long-term (i.e. less likely to be subject to significant debate) but also, within the period a Guideline applies. For example, abnormal market conditions that sustain over a period of months (or longer) would have a significantly lower impact on the allowed rate of return.

We therefore believe this approach is worthwhile considering because it does have certain features that appear to be consistent with what our customers have been telling us about their energy market experience (particularly in terms of stable and predictable outcomes).

If you wish to discuss this submission please contact me on (03) 9173 8218 or sandeep.kumar@jemena.com.au.

Yours sincerely

Sandeep Kumar

Sandeep Kumar
Manager Regulatory Analysis and Strategy