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

By email: rateofreturn@aer.gov.au

4 May 2018

Dear Warwick

Submission on concurrent expert sessions and discussion papers

The Australian Energy Regulator (**AER**) has invited submissions to the discussion papers and the concurrent expert sessions (**CES**) as part of review of the Rate of Return Guideline. Jemena Limited (**Jemena**) welcomes this opportunity to provide its views to the AER.

Jemena has been involved with developing the Energy Network Australia (**ENA**) and Australian Pipeline Gas Association (**APGA**) submissions. As well as endorsing the two submissions, we believe that it would be helpful to emphasise:

- our observations on the current review process;
- our views on approach to balance our customer and investor interests; and
- reaffirming Jemena's position of taking a principled approach to this incremental review, and our commitment to working collaboratively with the AER through this process.

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.

<u>Current Review Process</u>

As part of on-going consumer engagement, our customers have told us that they are concerned about the increasing cost of living and the pressure exerted by energy affordability. They are also concerned about volatility of energy bills.

Through our interactions with customer advocates, we understand that customers also have found it difficult to participate in industry consultations because of significant reliance on expert reports that are too technical and time consuming to meaningfully comment on. This was especially relevant for rate of return matters.

The CES process adopted by the AER is a significant improvement to earlier processes and progression towards reduced future reliance on expert reports. The setting up of customer reference group (**CRG**) also provided an avenue for candid direct discussions between industry and customers groups and provided opportunity to seek cooperation and share concerns. We appreciate AER's efforts in this regard.

We believe this is an evolutionary process and can be further refined during the year and as part of future guideline process by:

1. Expanding participation in the CES to observers (customers, businesses, investors and other stakeholders) to understand the debate among experts. Currently the CEs is only limited to a very few people and it is worth considering the benefits of opening it up to a larger stakeholder audience similar to New Zealand Commerce Commission (**NZCC**).

2. Lowering reliance on multiple experts during CES by the AER. For example the AER used 3 separate experts compared to single experts by ENA, APGA and CRG.

3. Avoiding conflation of multiple issue at the same time and by providing longer time to stakeholders to carry out a thorough review. The AER released 5 papers on risk, gearing, beta, MRP and gamma which were relevant to the review of rate of return estimation in a short period of 1 month and 2 weeks before each concurrent session. To review these papers was challenging for industry representatives and customers representatives. The ability to provide a reasoned response was complicated by the AER's release of a profitability measure paper. We request the AER to carefully consider the timing and time frames for various discussion papers so as to avoid repetition of past concerns from stakeholders about their ability to meaningfully engage in such critical processes.

4. Implementing a process by which further submission of expert reports between development of joint report by CES experts and the draft guideline. The AER has engaged experts to prepare reports even after a joint expert report was prepared based on discussions during CES. Such a process naturally has triggered some concerns as to:

   - whether the AER itself is going to consider the CES discussions and joint report or
   - simply rely on the subsequent reports its own experts are preparing, that no other stakeholder will have opportunity to respond to before the draft guideline.

<u>Jemena's principled approach and position</u>

As pointed out in our response to the Issues Paper on review of Rate of Return Guideline dated 12 December 2017, Jemena consider the following principles important to guide our thinking on the matter and help collaborate with stakeholders:

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.

Keeping these principles in mind we recommend the following positions on various rate of return matters –

Issue	Jemena's preliminary position
Return on Equity	
Financial model	Continue with Foundation model approach that combines properties from other models such as DGM and Black CAPM. This results in the estimates more aligned with empirical evidence and realistic expectations. This promotes accuracy and sustainability of outcomes.
Risk free rate averaging period	Extend averaging period from a fixed 20 business days to a longer 60 business days to avoid lottery type outcomes for both customers and investors. This will promote stability and consistency.
Equity Beta	Maintain beta at 0.7 due to lack of any domestic evidence to show significant changes in risk profile of businesses. Infact it is well understood among stakeholders that there is increased stranding risk as a result of technological changes but we understand from the CES that this risk may be non-systematic in nature and therefore may require compensation through cash flows (in form of accelerated depreciation or higher operating expenditure allowance to cover for higher insurance costs) rather than rate of return allowance. We also recommend AER consider future guideline review and develop a method to increase the sample size, similar to NZCC. This has resulted in better accuracy, stability and predictability of results due to larger size of sample. The pros and cons of this approach need to be considered against the fact that by the time the AER reviews its next guideline it may only have three or less (very different) beta estimates under its current approach to determine an average benchmark beta for the entire industry. Such as estimate would be imprecise and volatile. It is important that the AER adopt a longer term vision on this issue and consider using a sufficiently broader sample that can be used in future guideline reviews.
MRP	Continue combining historical and forward looking methods, but apply transparent weights to combine these. Adopt high level principle to allow for changes in benchmark MRP level (for example only change the MRP estimate if it is more than 35bp different to the existing estimate). Such an approach will promote stability, predictability and sustainability. Also consider the relationship between the averaging method and the compounding of return within PTRM.

Statistical imprecision	Currently AER's exercise of judgement in selecting parameter point estimates is unclear to stakeholders. An optional approach that the AER could consider to apply transparent judgement is to adopt NZCC's approach of using a 67th percentile WACC based on standard errors of estimates. Such an approach will promote sustainability and lower cost regulatory outcome. However to do so will require AER to change its approach on beta and MRP to a more mechanistic approach similar to NZCC.
Fixing beta and MRP	We encourage the AER to fix the beta and MRP in the guideline to 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
Return on Debt	
Averaging period	No change in required to current method as it provides sufficient flexibility to investors to raise debt and undertake hedges. This would promote stability, consistency and predictability.
Transition approach	No change is required as businesses are already under transition to trailing average approach. This would promote stability, consistency, predictability and sustainability. A change back to the 'on the day' approach at this stage will result in another transition and further delay in reaching an efficient financing approach.
Credit rating	No change required to the approach. This would promote stability and predictability.
Data curves	Review efficiency and availability of data curves and only change from current approach if desirable. This would promote accuracy, predictability and sustainability. We recommend not combining more than two data curves as it will result in more administrative work and cost for all stakeholders to source, interpolate/extrapolate and update data curves for price review proposals, decisions and tariff variation notices.
Gearing	Only consider change if there is material difference in average gearing level. Currently the evidence shows that there is no need to change the benchmark gearing level.

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

Yours sincerely

Sandeep Kumar
Manager Regulatory Analysis and Strategy