SA Power Networks CitiPower Powercor Australia Australian Gas Infrastructure Group united energy

25 September 2018

Mr Warwick Anderson
General Manager
Australian Energy Regulator
GPO Box 3131
CANBERRA ACT 2601

Via: [redacted]

Dear Warwick

Draft Rate of Return Guideline

SA Power Networks, Australian Gas Infrastructure Group, CitiPower, United Energy and Powercor (**the Businesses**) are pleased to provide this submission in response to the AER's Draft Rate of Return Guideline and Explanatory Statement published in July 2018 (**Draft Guideline**).

Energy Networks Australia has submitted a very comprehensive submission in response to the Draft Guideline on behalf of the industry. The Businesses have provided input into and fully support and rely on that submission. As with previous submissions, in this document the Businesses highlight matters arising from the Draft Guideline that we consider are particularly important in moving towards a final Rate of Return Guideline.

What has changed since the 2013 Rate of Return Guideline?

In short:

- nothing in respect of the finance theory underpinning the 2013 Guideline; but
- a lot in respect of the declining level of investment by networks and lower returns achieved.

The AER in its Issues Paper published in October 2017 said:

> *…we consider this review should seek to build on the current Guideline rather than start afresh. There are a number of aspects of the current approach that are reliant on market data and empirical analysis, and this material would clearly need to be updated. However, there are a number of aspects of the current approach that are driven by finance theory and available academic literature. We not aware of any significant new developments in this area that might warrant us taking a new approach.*[1]

As we have said in our previous submissions, we have been supportive of an incremental review of the 2013 Guideline. A significant amount of analysis, precedent and investment in networks underpins the 2013 Guideline. The threshold for any material changes from the current Guideline should be considered to be high given there has been no material changes in finance theory since the 2013 Guideline. This has the additional benefit of providing regulatory certainty and stability, thereby promoting the achievement of the national electricity and national gas objectives (NEO/NGO).

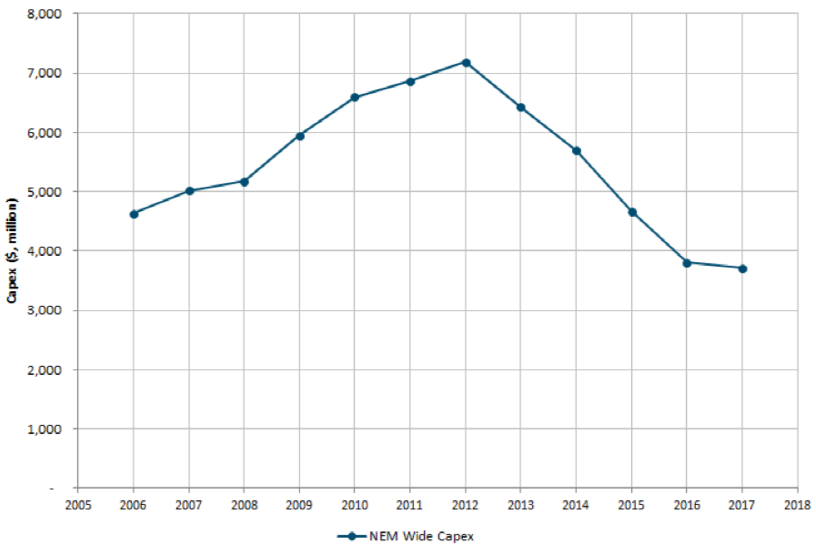
[1] AER Issues Paper, Review of Rate of Return Guideline, October 2017, p. 8.

However, in undertaking an incremental review and in carrying out the task of formulating a guideline that the AER is satisfied will, or is most likely to, contribute to the NEO and NGO to the greatest degree, it is critical that the impact of the 2013 Guideline on revenue, prices and ongoing investment be considered. In particular, to satisfy itself the final Guideline will contribute to the objectives over the period during which it will apply, the AER must give serious consideration to whether the previous Guideline has been effective in encouraging efficient investment in networks in the long run interests of consumers.

Section 3 of the Energy Networks Australia submission shows that:

1. Following the significant reduction in the allowed returns in the 2013 Guideline, further declines in the risk free rate have led to further material reductions.
2. The effect has been that returns to networks per dollar of investment have also materially reduced (by more than 30% on average).
3. Since the 2013 Guideline, RAB growth has been very modest, with capital expenditure declining since that time with its lowest point in 2017, as shown below.

Figure 3.3: Combined distribution NSPs Capex in NEM



Source: AER
Note: values in 2017 real dollar terms.

4. The minimal growth in RABs since the 2013 Guideline indicates the rates of return derived from the 2013 Guideline may not have been sufficient to encourage efficient investment, and certainly have not resulted in any over-investment in networks.
5. While there have been increases in customer bills, the network component of customer bills has declined.

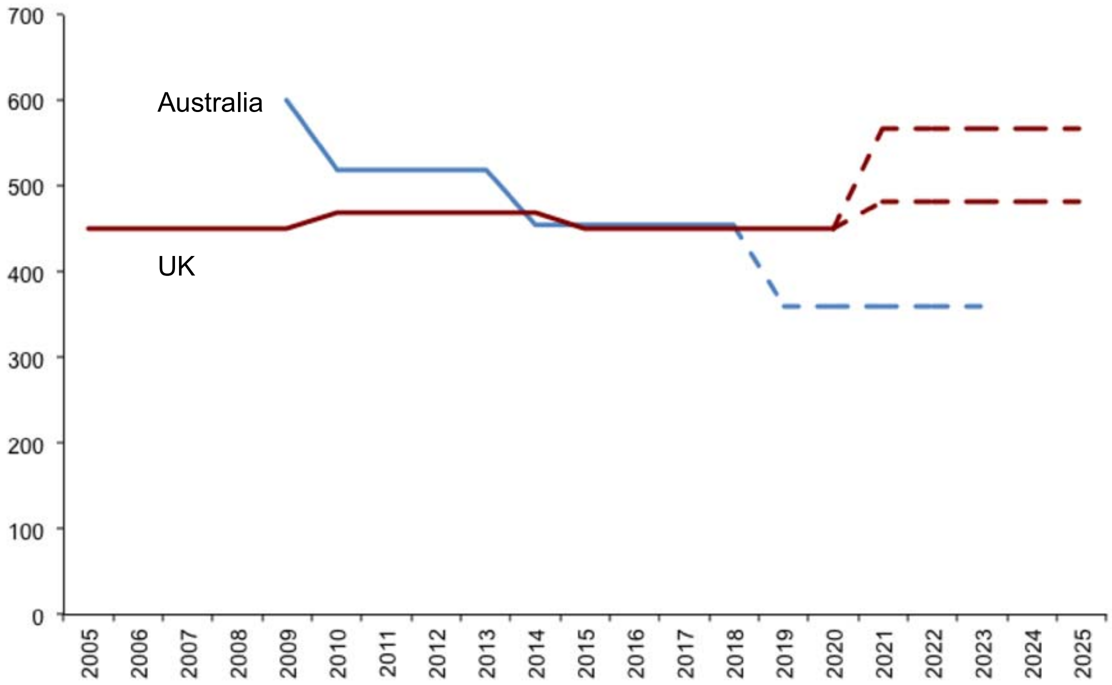
There is no evidence that allowed returns in the 2013 Guideline were too high, and, if anything the evidence points to constraints on efficient investment, which is not in the long term interests of consumers.

The AER is now proposing to reduce allowed returns even further. The Businesses submit that, in the context of the historically low returns currently provided by the 2013 Guideline and the impacts outlined above and in section 3 of the Energy Networks Australia submission, the Draft Guideline if applied will likely have the effect of further constraining networks' ability to undertake sustainable investment. This would be contrary to the achievement of the objectives.

Comparative rates of return

The Energy Networks Australia submission attaches a report from UK economist John Earwaker titled "*The AER's Draft WACC Guideline: An International Perspective*" (**Earwaker Report**). That report compares the equity risk premium proposed in the Draft Guideline against international regulatory decisions. Mr Earwaker compares the Draft Guideline to equity risk premia in the UK, New Zealand, Europe and the US and Canada over recent years. In relation to the UK, the report compares historic risk premium allowed by the AER and Ofgem, and including Ofgem's initial thinking on the likely range for the 2023-2028 period:

Figure 1: Premium in the allowed cost of equity over the risk-free rate (basis points)[2]



The analysis shows more stability in Ofgem's calculations historically and that while the 2013 Guideline was broadly in line with Ofgem's position, on a forward looking basis, "*Australia would in future sit quite markedly below returns in Great Britain if the AER and Ofgem were to go ahead and implement their latest proposals*"[3] The report considers whether there are any differences in risk that would drive the difference in returns, but concludes that, if anything, the investor community would

[2] Page 5 of the Earwaker Report

look at Australian and UK networks as similar types of infrastructure investments, and the MRP could be slightly higher in Australia due to broader country factors.[4]

A very similar story is told in respect of New Zealand[5] and in respect of Europe. The report finds that the only countries where regulators have set lower returns are Austria, Romania and Lithuania, with most established regulatory frameworks allowing returns in the same range as the UK and New Zealand.[6]

The report's conclusions are telling[7]:

> *"Based on the evidence, I am able to say with some confidence that the combination of the AER's proposed 6.0% MRP and 0.6 equity beta would give a level of equity return to investors in regulated electricity distribution network that is almost without parallel anywhere else in the world.*
>
> *This does not automatically mean that the calibrations in the AER's draft guideline are wrong. Like most regulatory practitioners, I recognise that WACC estimation is an imprecise science and that mainstream thinking about methodologies and numbers is constantly marching on. In my view, the material set out above does, however, raise questions and challenges the AER to confirm that the evidence it has assembled in its review really does take it to an end point that the likes of Ofgem, the Commerce Commission and numerous other regulators have not previously countenanced."*

and in the concluding observations[8]:

> *"The picture that emerges from the above discussion is one in which the AER is repeatedly taking extreme positions in its draft WACC guidelines. I am always very hesitant to say that one approach to WACC estimation is definitively 'right' and another approach is definitively 'wrong' and it is not my intention to take any such position in this paper. However, I do think it is important for regulators to be 'in the pack' with expert opinion, and yet it appears that the AER's draft guidelines on the cost of equity, taken as a package, are pushing right to the very boundary of what until now could have been regarded as mainstream regulatory thinking.*
>
> *In this regard, the contrast between the 2018 draft guidelines and the previous 2013 guidelines is quite stark. In the space of five years, there has not been a huge shift in the evidence base – if anything, the data is pointing towards there having been a small increase in the cost of equity capital relative to the return on riskless assets. I would therefore characterise the move from a 455 basis point premium over the risk-free rate to a premium of only 360 basis points as a switch from a middle-of-the-road reading of the evidence to a very stretching, possibly over-stretched, take on the cost of equity."*

The analysis in the Earwaker Report confirms submissions previously made by Energy Networks Australia and the Businesses that the return on equity proposed in the Draft Guideline is an outlier and is not commensurate with efficient financing costs. While the need for the rate of return to be commensurate with efficient financing costs (in the allowed rate of return objective) is not a specific requirement under the new binding guideline legislation, the Businesses submit that if allowed returns

[3] Ibid

[4] Section 3.2, page 6.

[5] Section 4.1 on pages 6 to 7.

[6] Section 4.2, pages 8-10.

[7] At section 4.4, page 11-12.

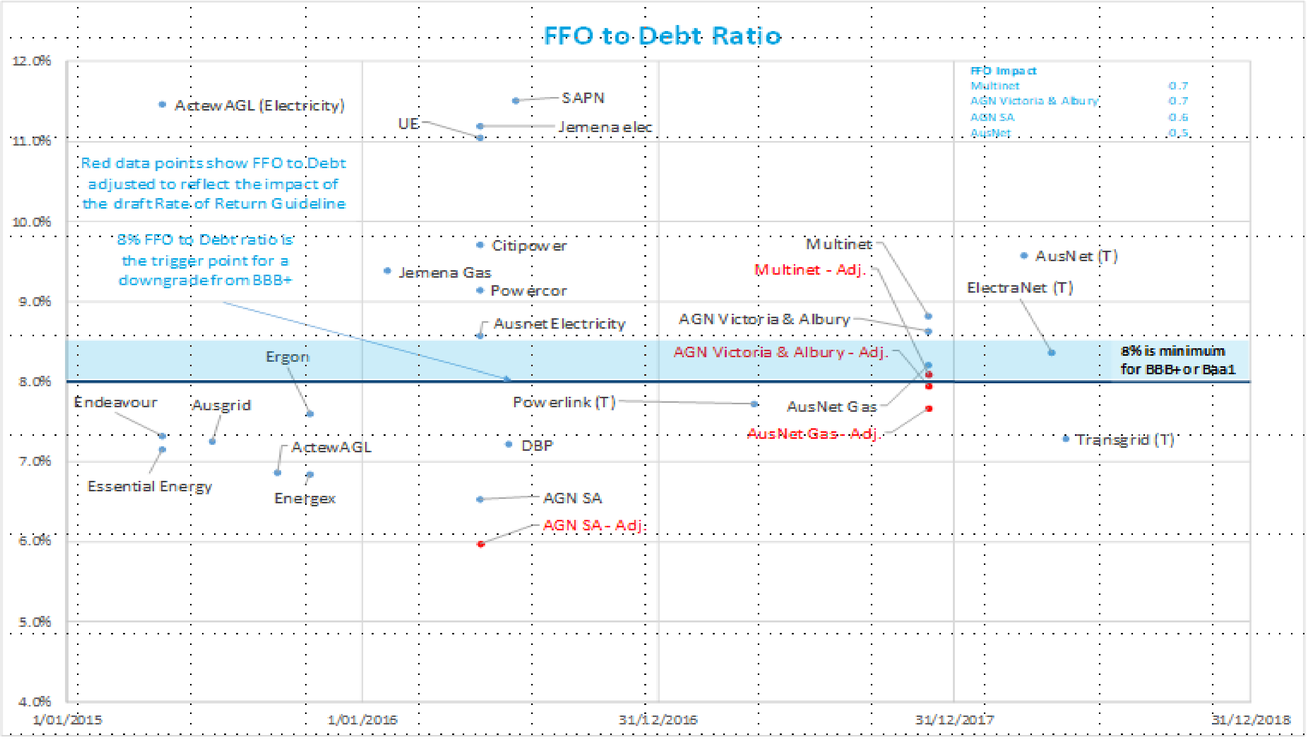
[8] Section 6, page 14.

do not reflect efficient financing costs, the AER will not be able to satisfy itself that the Guideline will contribute to the national electricity and gas objectives.

Investors in our Businesses have interests in other jurisdictions (including NZ and the UK) and have a choice where they will invest their capital. The lower rates of return in Australia will make investment less attractive in Australia and discourage efficient investment, which is contrary to the long term interests of consumers.

We are also concerned about potential impacts on financeability. Ratings agencies, when performing credit ratings, pay particular attention to funds from operations to debt as a key dynamic ratio, and when this falls, the risk of a credit downgrade increases. The figure below shows the FFO/debt ratio for regulated businesses now and subsequent to this latest change to the WACC in the Draft Guideline, and suggests that many businesses may in fact face a credit rating downgrade.

This would obviously be a poor outcome for efficient investment and for the financing costs of the efficient entity in forthcoming regulatory decisions. Moreover, any resultant increase in financing costs stemming from a credit downgrade would most likely materially increase the cost of providing networks services, even if the material reductions proposed in the Draft Guideline were to apply.



Confidence in the review and resulting Guideline

A further factor that will impact on the ability of the Guideline to contribute to the NEO/NGO to the greatest degree is stakeholder confidence in the process and the resulting final Guideline. We are keen to continue to work with stakeholders, including the AER, on a final guideline that is "capable of being accepted".

It is clear since the release of the Draft Guideline that industry has not accepted the proposed Guideline which, in our view, primarily reflects that the decision is not supported by the evidence. There is a view that most evidence submitted by industry has not being accepted, fairly considered, or alternatively, has been given little weight relative to other evidence that results in a decrease in returns.

Section 4 of Energy Network Australia's submission sets out in detail the industry's concerns with the process, which we support. These concerns, which directly impact confidence in the process and the ability to achieve capable of acceptance include that:

1. The only changes the AER proposes to make to its parameter estimates are to reduce the allowed return, despite the fact that all the relevant evidence has moved in the opposite direction (increased) since the 2013 Guideline, particularly in relation to equity beta and MRP. The result is that the AER's parameter estimates are not based on the evidence and cannot reflect the best empirical estimate. In addition, the AER places inconsistent weight on the evidence on which it does rely. Very high standards are applied to the evidence that would support an increase in allowed returns, but lower standards are applied to evidence supporting reduced returns. In the case of the MRP, the AER relies on evidence its own expert rejects as insufficiently robust, in order to establish the argument that the DGM is unreliably imprecise.

2. The AER states that its review of the Guideline is "incremental", an approach we have supported. However, it is clear that the practical effect of the AER's approach is far from incremental, in particular in relation to the continued application of the foundation model approach. As section 6 of the Energy Networks Australia submission explains, the AER's version of the foundation model approach in the Draft Guideline is very different to the 2013 Guideline. Evidence (such as the theory of the Black CAPM for equity beta and the dividend growth model for the market risk premium) which played a role in and influenced the parameter estimates in the 2013 Guideline now plays no role at all and has no impact on the parameter estimate. In our view, the foundation model has been abandoned, which is inconsistent with an incremental review on the basis of no change in finance theory.

3. A significant amount of time and resources was invested by all stakeholders and the AER in the concurrent evidence sessions in this Review. The result of those sessions was a Joint Expert Report which recorded key areas of agreement and disagreement between experts. However, even where all experts have reached agreement on a matter, the AER has largely ignored the agreed findings. In a number of cases the AER has done so so on the basis that its expert may have disagreed if given more time to consider.[9] The Businesses were very supportive of the concurrent expert sessions, on the basis it would assist in narrowing the areas of disagreement between experts and provide strong guidance to the AER and stakeholders in considering the evidence presented in this Review.

[9] AER Explanatory Statement, page 247 in relation to the weight to be given to equity beta estimates for delisted firms. Additionally on page 264 in relation to the MRP

However, the AER's treatment of the Joint Expert Report supports a view that the outcome is more important than the evidence. This is reinforced by the AER's return on equity cross-checks. Four of the five cross-checks which compare the proposed equity risk premium of 3.6% with other estimates of the equity risk premium, are failed. The only cross check which is passed (and even this rests on a dubious and selective interpretation of the data) is one which the AER rejected in 2013 as being insufficiently robust, yet the AER is not satisfied the cross-checks suggest there should be an adjustment.

4. Similar issues arise in relation to the Independent Panel Report. The Independent Panel was established as a means of promoting stakeholder confidence that the final Guideline will be capable of achievement of the NEO/NGO.[10] However, the Panel was asked to opine on a question which does not assist the AER in satisfying itself that the Guideline will or is likely to contribute to the national electricity and gas objectives to the greatest degree. The Panel was also given insufficient time to consider the vast amount of information and necessarily has had to focus on the AER's Draft Guideline and Explanatory Statement. The result is a report that fails to deliver confidence in the process or the resulting Guideline. This is self-evident from the fact the report focusses on issues that are uncontentious, immaterial or irrelevant (for example, the number of decimal places gamma should be estimated to), with the majority of the recommendations made by the Panel suggesting the AER provide further explanation or greater clarity about its reasoning. It is unclear how providing further reasoning, which the Independent Panel has not seen (nor have other stakeholders), could result in the Guideline then becoming capable of promoting achievement of the NEO/NGO.

5. In relation to gamma, we have recently become aware of a further note the AER appears to have obtained from the ATO in relation to taxation statistics, published without warning only a week before the closing date for these submissions. The new note is titled "*Franking account balance – tax of time series data from Taxation Statistics"* and appears to have been obtained by the AER because it was not satisfied with the previous ATO notes. No explanation of how the note came about or what it is responding to has been provided. The absence of explanation or notice of publication is of concern, particularly in light of the fact the AER had published two prior ATO notes and had facilitated discussions between ATO staff, AER staff and industry representatives to better understand the ATO information. Energy Networks Australia's submission sets out some further concerns with the substance of the note, which we support.

Achieving Capable of Acceptance

The concerns noted above and in the Energy Networks Australia submission, if not addressed in making the final Guideline, will result in a Guideline that is not capable of acceptance, does not have the confidence of investors (who will be incentivized to invest elsewhere) and will not be capable of contributing to the achievement of the NEO/NGO.

[10] Independent Panel Report, 7 September 2018, page I.

This outcome would be disappointing given the large effort by all stakeholders to achieve a Guideline that appropriately balances all interests, is fair and based on robust evidence and ultimately achieves the NEO/NGO. In making the final Guideline, we are keen to see the AER:

- **Improve the link between the outcome in the current guideline, the updated evidence and the AER decision**.

  For example, as noted above the evidence in regard to equity beta and MRP has increased, yet the Draft Guideline moves in the opposite direction, and by a material amount. This is supported by the relevant cross-checks that confirm a conclusion that the return on equity is too low.

  We are therefore seeking that the AER clearly explain how the updated evidence has led to a change in current parameters.

- **Deliver an incremental review as intended**

  The Businesses and the AER are in agreement that there has been no change in finance theory and the review should not "start afresh". This set the tone for the review. The Draft Guideline delivered the complete opposite, and in the absence of robust evidence in support. Clear examples include use of geometric means in setting the market risk premium, greater reliance on obsolete data in setting equity beta and the lack of any role for the dividend growth model and the Black-CAPM (all factors that would have otherwise supported, at least, the current return on equity). The AER also took a completely different approach to gamma.

  We are therefore seeking that the AER clearly explain the change in evidence/theory that has led to changes in approach from the current Guideline.

- **Engage with all the evidence received through consultation process**

  This requires that information received through various consultation steps be fully and fairly considered in reaching a final Guideline, to avoid the potential concern of a process being put around an outcome (which criticism was raised in relation to the recent inflation review). We are therefore seeking that the AER consider all evidence and explain how this has informed its decision.

- **Better consideration of the impact of any changes to returns**

  The material and one-off changes proposed in the Draft Guideline will send a signal to investors for the current period, but also future periods (i.e. what can they expect in the next guideline). This is particularly the case given the Draft Guideline places Australia at the low end of allowed returns globally (as set out in the Earwaker Report).

  We are therefore seeking that the AER consider the potential impacts on investment and financeability of businesses.

We are hopeful that consideration of the points made in this submission, the detailed submissions and evidence provided in the Energy Networks Australia submission, in particular in relation to the equity beta, market risk premium and gamma will result in a final Guideline that is capable of being accepted.

Yours sincerely

[redacted]	[redacted]	[redacted]
Patrick Makinson	Renate Vogt	Craig de Laine
Company Secretary	General Manager Regulation	General Manager- People & Strategy