30 March 2015

Mr Warwick Anderson
General Manager—Network Regulation
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Mr Anderson

Recent Risk Free Rate movements and the Return on Equity

On 14 April 2014, the Australian Energy Regulator (**AER**) wrote to ActewAGL Distribution in relation to nominating the averaging period for the risk free rate that it proposed to use for the upcoming final decision for the ACT Electricity network. In its regulatory proposal provided to the AER in July 2014 (**SRP**), ActewAGL Distribution noted that *"If the AER accepts ActewAGL Distribution's method of estimating the return on equity..., ActewAGL Distribution does not take issue with the AER's proposed averaging period"*.[1] ActewAGL Distribution maintained this position in its revised regulatory proposal submitted to the AER in January 2015 (**RRP**).[2]

In its draft decision, the AER did not accept ActewAGL Distribution's proposed methodology to estimate the return on equity and determined an overall return on equity of 8.09%. This was based on a nominal risk free rate of 3.54% measured from 17 September to 15 October 2014 and a MRP of 6.5% consistent with the AER's foundation model outlined in its Rate of Return Guideline.

The averaging period nominated by the AER in its 14 April 2014 letter, of 9 February 2015 to 6 March 2015, has recently concluded. ActewAGL Distribution notes that the risk free rate measured over that period is 2.55%. This is a reduction of 0.99 pts since the AER's draft decision in November 2014, over a period of four months. Applying this risk free rate to the approach set out in the AER's draft decision would generate a return on equity of 7.10%, which is also a reduction of 0.99 pts since the publication of the AER's draft decision, again over a period of only four months[3]. A consideration of the performance of CGS yields suggests that the yields have been driven down by anomalous factors[4]. In recent months, we have witnessed the unprecedented phenomenon of negative yields on various European government bonds, which is a powerful demonstration of the strength of demand for low-risk assets. The evidence suggests that CGS yields have been impacted by:

(a) a shrinking supply of AAA rated sovereign debt globally;

(b) heightened risk aversion and increased levels of perceived risk, especially in the context of heightened concern over Greece leaving the Eurozone; and

[1] ActewAGL Distribution, Subsequent Regulatory Proposal 2015-19, July 2014, p 275
[2] ActewAGL Distribution, Revised Regulatory Proposal 2015-19, January 2015, p 468
[3] See attachment 1 for detailed calculations.
[4] This is explored further in a speech given by Assistant Governor Guy Debelle at Reserve Bank of Australia on 16 March 2015 who notes that *"The most plausible explanation* [to the low levels of yield globally and domestically] *relates to a shortage of 'risk-free' assets although with term premia so low, it's not clear how risk-free they actually are."* The details of his speech can be found via this link: http://www.rba.gov.au/speeches/2015/sp-ag-2015-03-16.html

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(c) heightened demand for liquid assets, including demand produced by changes in banking regulations.

These matters are highly unlikely to be decreasing the required ROE for a benchmark entity (indeed the second matter is likely to be increasing the return on equity) but the effect of the AER's approach of using the SL-CAPM populated with a largely historical MRP is to drive down the return on equity to a low level.

The significant deterioration in the return on equity is of great concern to ActewAGL Distribution and provides further emphasis to the evidence provided in ActewAGL Distribution's SRP and RRP, that is, the evidence does not indicate that the market return falls one-for-one with the risk-free rate, or that the MRP has remained constant.

To the contrary, forward-looking estimates from SFG's DDM and independent expert reports (referred to in ActewAGL Distribution's SRP and RRP[5] and expert reports[6]) indicate that the MRP has increased significantly since the AER's Rate of Return Guideline was published. This is clear even from the AER's DDM estimates. In its RRP in January 2015, ActewAGL Distribution provided evidence that the MRP has increased since July 2014 when the SRP was submitted as the risk free rate has decreased. In its RRP, ActewAGL Distribution also emphasised that the AER has placed too much weight on historical averages and fails to take into account relevant and current evidence in relation to the MRP, which results in an estimate that does not reflect prevailing market conditions.

ActewAGL Distribution was unable to provide information about the actual risk free rate in its February Submission as the nominated averaging period had not been completed. ActewAGL Distribution therefore requests that this letter be considered by the AER and taken into account before its final decision is reached.

Should you wish to discuss any of the matters raised above please contact myself or Mr Usman Saadat on (02) 6248 3806.

Yours sincerely

Björn Tibell

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Acting Director Regulatory Affairs and Pricing

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[5] ActewAGL Distribution, Subsequent Regulatory Proposal 2015-19, July 2014, p 268-270 and ActewAGL Distribution, Revised Regulatory Proposal 2015-19, January 2015, p 458-464

[6] SFG Consulting, Alternative versions of the dividend discount model and the implied cost of equity, 15 May 2014; SFG Consulting, The required return on equity for regulated gas and electricity network businesses, 27 May 2014; SFG Consulting, Share prices, the dividend discount model and the cost of equity for the market and a benchmark energy network, 13 February 2015; SFG Consulting, The required return on equity for the benchmark efficient entity, 13 February 2015; Incenta, Further update on the required return on equity from Independent expert reports, February 2015