Attachment 3 - Rate of return

2025–30 Regulatory Proposal

January 2024

SA Power Networks

Empowering South Australia

Company information

SA Power Networks is the registered Distribution Network Service Provider for South Australia. For information about SA Power Networks visit sapowernetworks.com.au

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Disclaimer

This document forms part of SA Power Networks' Regulatory Proposal to the Australian Energy Regulator for the 1 July 2025 to 30 June 2030 regulatory control period. The Proposal and its attachments were prepared solely for the current regulatory process and are current as at the time of lodgement.

This document contains certain predictions, estimates and statements that reflect various assumptions concerning, amongst other things, economic growth and load growth forecasts. The Proposal includes documents and data that are part of SA Power Networks' normal business processes and are therefore subject to ongoing change and development.

Whilst care was taken in the preparation of the information in this Regulatory Proposal, and it is provided in good faith, SA Power Networks, its officers and shareholders accept no responsibility or liability for any loss or damage that may be incurred by any person acting in reliance on this information or assumptions drawn from it for a different purpose or in a different context.

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Note

This attachment forms part of our Proposal for the 2025–30 Regulatory Control Period. It should be read in conjunction with the other parts of the Proposal.

Our Proposal comprises the overview and attachments listed below, and the supporting documents that are listed in Attachment 20:

Document	Description
	Regulatory Proposal overview
Attachment 0	Customer and stakeholder engagement program
Attachment 1	Annual revenue requirement and control mechanism
Attachment 2	Regulatory Asset Base
Attachment 3	**Rate of Return**
Attachment 4	Regulatory Depreciation
Attachment 5	Capital expenditure
Attachment 6	Operating expenditure
Attachment 7	Corporate income tax
Attachment 8	Efficiency Benefit Sharing Scheme
Attachment 9	Capital Expenditure Sharing Scheme
Attachment 10	Service Target Performance Incentive Scheme
Attachment 11	Customer Service Incentive Scheme
Attachment 12	Demand management incentives and allowance
Attachment 13	Classification of services
Attachment 14	Pass through events
Attachment 15	Alternative Control Services
Attachment 16	Negotiated services framework and criteria
Attachment 17	Connection Policy
Attachment 18	Tariff Structure Statement Part A
Attachment 18	Tariff Structure Statement Part B - Explanatory Statement
Attachment 19	Legacy Metering
Attachment 20	List of Proposal documentation

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1 Overview

This Attachment outlines the derivation of the allowed rate of return for SA Power Networks for the 2025–30 regulatory control period (**RCP**).

2 Rule requirements

Clause 6.5.2 of the National Electricity Rules (**NER**) provides that the return on capital for SA Power Networks for a regulatory year is to be calculated by multiplying the value of our regulatory asset base by the allowed rate of return.

The allowed rate of return is set by the Australian Energy Regulator's (**AER's**) Rate of Return Instrument which outlines the way to calculate the return on capital and set the value of imputation credits (**gamma**) at 0.57.

SA Power Networks' 2025–30 Regulatory Proposal (**Proposal**) has been prepared in accordance with the updated 2022 Rate of Return Instrument published by the AER in June 2023 (**2022 Instrument**).

3 Return on Equity

Under the 2022 Instrument the allowed return on equity must be calculated as an estimated risk free rate plus a market risk premium of 6.2 percent multiplied by an equity beta of 0.6.[1] This equates to an equity risk premium of 372 basis points over the estimated risk free rate.

The risk free rate is to be estimated based on an average of the yield on 10 year Commonwealth Government Bonds over an averaging period of between 20 and 60 business days. Regulated distribution network service providers (**DNSPs**) are free to choose this averaging period subject to the requirements set out in the 2023 Instrument.[2]

Averaging period

SA Power Networks has applied the approach to setting the risk free rate set out in the 2022 Instrument, which is to select an averaging period agreed with the AER that will remain confidential until the period has passed.

The proposed confidential averaging period for the setting of the risk free rate for each year of the 2025–30 RCP is outlined in a confidential letter sent to the AER on 31 January 2024.

1 2022 Instrument clause 4.

2 2022 Instrument clauses 5-8.

4 Return on Debt

The 2022 Instrument continues to apply key elements of the approach adopted in the 2018 Guideline for estimating the return on debt. This is based upon a benchmarking approach to estimating the allowed return on debt, based on a term of 10 years, credit rating of BBB+ and calculated as a 10-year trailing average.

In this Proposal, we adopt the Return on Debt approach in accordance with the 2022 Instrument.

Averaging period

The 2022 Instrument proposes that there be an averaging period set for each year of the relevant RCP from which the data for the allowed return on debt will be drawn. The 2022 Instrument states that the periods can be proposed by the DNSP in its initial regulatory proposal and agreed by the AER on a confidential basis.[3]

The proposed confidential averaging period for the setting of the return on debt for each year of the 2025–30 RCP is outlined in a confidential letter sent to the AER on 31 January 2024.

5 Imputation credit value (gamma)

The value of imputation credits (or gamma) is an important input into the calculation of the corporate income tax allowance. Under the Australian imputation tax system, shareholders may receive imputation tax credits with dividends, which offset tax liabilities. Imputation credits are therefore valuable to investors and are a benefit to investors in addition to any cash dividend or capital gains they receive from owning shares.

The NER recognise that a DNSP's allowed revenue does not need to include the value of imputation credits. Therefore, an adjustment for the value of imputation credits is required. The adjustment which is employed by the NER, is via the revenue granted to a DNSP to cover its expected tax liability. Specifically, the NER require that the estimated cost of corporate income tax be determined in accordance with a formula that reduces the estimated cost of corporate tax by the 'value of imputation credits'.

In this Proposal, we adopt a gamma value of 0.57 in accordance with the 2022 Instrument.[4]

[3] 2022 Instrument clause 23.

[4] 2022 Instrument clause 27.

6 Rate of return

The placeholder proposed allowed rate of return for SA Power Networks for the 2025–30 RCP is shown in Table 1. These rates are the average forecast over 2025–30 and will be updated with latest forecasts for the purposes of the AER's draft and final determinations.

Table 1: Rate of return assumptions

Rate of return assumptions	Proposed
Nominal Risk Free Rate	4.27%
Nominal Pre-tax Cost of Debt	4.98%
Market Risk Premium	6.2%
Equity Beta	0.6
Post-tax Nominal Return on Equity	7.99%
Nominal Vanilla WACC	6.18%
Gamma	0.57

The placeholder nominal risk free rate is based on an average of the 20 business days ended 29 September 2023. The placeholder pre-tax cost of debt is based on the actual rate for the 2023/24 regulatory year, rolled forward with current rates.

7 Forecast Inflation

The NER requires the post-tax revenue model (**PTRM**) to include a method that the AER determines is likely to result in a best estimate of inflation[5]. Our estimate of expected inflation is currently 2.50 percent. This is a placeholder which will be updated in our Revised Proposal and the AER's final determination based on the latest available information at the time.

It is an estimate of the average annual rate of inflation expected over a five year period, in accordance with the AER's methodology set out in the PTRM.

Our estimate of expected inflation is estimated as the geometric average of five annual expected inflation rates. We use the Reserve Bank of Australia (**RBA**) forecasts of inflation for the first two years of SA Power Networks' 2025–30 RCP as the first two annual rates. We then apply a glide-path to the mid-point of the RBA's inflation target band for the remaining three annual rates.

5 NER 6.4.2(b)

8 Equity and Debt raising costs

The compensation for the required rate of return on debt and equity, does not cover the transaction costs associated with raising debt and equity. In accordance with AER's PTRM methodology, we are proposing debt raising costs in the operating expenditure (**opex**) forecast because these are regular and ongoing costs which are likely to be incurred each time service providers refinance their debt. On the other hand, equity raising costs are included in the capital expenditure (**capex**) forecast because these costs are only incurred once and would be associated with funding specific capital investments.

8.1 Equity raising costs

Equity raising costs are transaction costs incurred when DNSPs raise new equity in order to fund capital investment. Equity raising costs are the costs of raising equity that would be incurred by a prudent service provider acting efficiently. Accordingly, the AER provides a benchmark allowance to recover an efficient amount of equity raising costs, when a DNSP's capex forecast requires an external equity injection to maintain the benchmark gearing of 60 percent.

Our calculations are contained in the completed PTRM submitted with this Proposal. They indicate that under the AER’s modelling approach, an external equity injection is not required to maintain the benchmark capital structure over the 2025–30 RCP. The PTRM accordingly calculates an equity raising cost allowance of zero for the 2025–30 RCP.

This calculation will be updated for the purposes of the AER’s draft and final determinations.

8.2 Debt raising costs

Debt raising costs are transaction costs incurred each time debt is raised or refinanced. These costs may include arrangement fees, legal fees, company credit rating fees and other transaction costs. Debt raising costs are an unavoidable aspect of raising debt that would be incurred by a prudent service provider and data exists to enable us to estimate these costs.

Our actual debt raising costs are reported as finance charges rather than opex. Therefore, a separate debt raising allowance must be included in our opex to align with the regulatory treatment.

The debt raising costs allowance is calculated in the PTRM submitted with this Proposal and is summarised in Table 2. Our proposal is for debt raising costs of 8.50 basis points per annum, consistent with the rate in our 2020 Determination. The AER’s analysis of debt raising costs in the New South Wales Draft Decisions indicate an annual total debt raising cost of 8.29 basis points per annum, which is not materially different.

Table 2: Forecast Debt raising costs ($ million, nominal)

	2020/21	2021/22	2022/23	2023/24	2024/25	2020–25 RCP
Debt raising costs – SCS	2.7	2.7	2.7	2.8	2.9	13.8

Glossary

Acronym / term	Definition
2022 Instrument	2022 Rate of Return Instrument published by the AER in June 2023
AER	Australian Energy Regulator
Capex	Capital expenditure
DNSP	Distribution network service providers
gamma	The value of imputation credits
NER	National Electricity Rules
Opex	Operating expenditure
Proposal	Regulatory Proposal 2025–30
PTRM	Post-Tax Revenue Model
RCP	Regulatory Control Period
RBA	Reserve Bank of Australia
Revised Proposal	Revised regulatory proposal for the 2025–30 Regulatory Control Period