Rate of return

Overview for consumers

About the Rate of return

The AER regulates electricity poles and wires and gas pipelines. These networks are monopolies that supply essential services and, without regulation, the owners of these networks could charge excessive prices.

We set the amount of revenue these networks can earn, including a compensation for the money they have invested in their poles, wires and pipelines. We call this reward the rate of return on capital (or rate of return for short).

The rate of return is part of the revenue that networks recover from customers. We set the rate of return to cover the cost an efficient network would incur to raise its capital in the financial markets.

A rate of return should be high enough to encourage network owners to build the electricity and gas networks needed to supply you with electricity and gas, but not so high that you pay too much. The rate of return we set moves up and down with interest rates which generally relate to the state of the economy.

When we set the rate of return, we are looking into the future, but the tools and data available to undertake this task are imperfect. We need to make judgement calls in determining the appropriate level.

Consultation

We re-examine the rate of return every 4 years. We check whether our approach will still set it at the right level or whether adjustments are needed. We have just done this as part of our recent final decision.

In reaching our decision, we engaged extensively with stakeholders over a 2-year period. We set up a consumer reference group, retailer reference group and an investor reference group to provide insights, published 8 working papers for stakeholder submissions and held sessions with key experts.

The consumer reference group provided us insights into consumer perspectives by conducting interviews and workshops with consumer advocates and undertaking several consumer surveys during our review process.

Our draft decision was published in June 2022 for stakeholder consultation and we held 2 public workshops to hear from all interested parties.

We set up an Independent Panel of highly capable experts to review our draft decision. Their recommendations helped us make the best possible final decision.

Setting the rate of return

The rate of return is composed of the returns the owners of equity (shareholders) and owners of debt (debt holders) expect for their money. The overall required return is a weighted average of the return required on the equity and the return required on the debt used to fund the network investment. The weighting is 60% debt and 40% equity.

We do not set the rate of return with a specific network or project in mind. Instead, we set a benchmark across the sector. This provides incentives for networks to raise their capital at the lowest cost possible. We use information about the regulated networks to decide what a benchmark network might look like.

Our rate of return is set to match the risk of providing network services. This is done by adding an equity risk premium to the base rate to calculate the return on equity and directly estimating the total return on debt inclusive of the base rate and the debt risk premium. The base rate or the risk-free rate is computed from the rates the Australian Government pays for its long-term (10-year) borrowings.

Final 2022 rate of return[1]

We conclude that our current approach to setting the rate of return remains largely appropriate. Our final decision is mainly consistent with our 2018 approach to setting the rate of return, which produced an outcome that was neither too high nor too low in terms of consumer bills and investor returns. We are seeing good levels of interest in investing in energy networks, while at the same time the return does not appear excessively high.

Our equity risk premium estimate is slightly elevated to 3.72% compared with 3.66% for the 2018 Rate of Return Instrument. This is because we find the market risk premium estimate now at 6.2% compared with 6.1%. Our estimate of equity beta remains at 0.6. Taken together with the current risk-free rate of 3.60%, this results in a return on equity of 7.32%.

Under our unchanged approach to return on debt since 2013, every year we update one-tenth of a network businesses’ total debt using market interest rates for debt with a10-year term and credit rating of BBB+. Assuming a full 10-year trailing average, currently the return on debt is around 4.70%.

Our overall rate of return is 5.75%, which is a 60:40 weighted average of debt and equity.[2]

We think that the good level of interest in investing in networks will continue under our final decision.

In making our decision, we were conscious of consumer bill impacts. Under our approach, movements in market interest rates have a direct impact on consumer bills. However, these impacts are somewhat muted because:

- return on equity is calculated only once at each regulatory determination every 5 years – this means that, during the regulatory period, consumers do not pay for increases or receive reductions relating to changes in the risk-free rate that feed into our return on equity calculation
- return on debt only changes by one-tenth every year – therefore, changes in interest rates that feed into return on debt are paid for or received by consumers gradually.

[1] Although we published this Rate of Return Instrument in February 2023, we had planned to publish it in December 2022 and so continue to refer to it as the 2022 Instrument.

[2] All values referred to are calculated based on end of December 2022 data.