

Better Regulation: Draft rate of return guideline

30 August 2013

The Australian Energy Regulator (AER) commenced the Better Regulation program in December 2012. Today we released our draft rate of return guideline. This sets out improvements to the way we determine the return that electricity and gas network businesses can earn on their investments so consumers pay no more than necessary to support the investment needed to keep the networks operating.

What is the Better Regulation program?

The AER initiated the Better Regulation program following changes to the electricity and gas rules in late 2012. The program brings together improvements to our regulatory approach with the consumer focused reforms agreed by the Council of Australian Governments in December 2012.

The Better Regulation program delivers an improved regulatory framework focused on the long term interests of electricity consumers.

The Better Regulation program involves:

- extensive consultation on seven new guidelines that outline our revised approach to determining electricity network revenues and prices
- establishing a consumer reference group for our guideline development work
- forming an ongoing Consumer Challenge Panel
- improving our internal technical expertise and systems.

What is the rate of return?

The allowed rate of return is an estimate of the appropriate cost of funds for investment in the network. A good estimate of the rate of return is necessary to promote efficient prices in the long term interests of consumers. The rate of return is calculated as a weighted average of the returns on equity and debt.

When a network business spends money on an asset, for example a new substation, the value of that substation is added to its regulatory asset base. The business' regulatory asset base is the total value of all the capital investments it makes to supply consumers with electricity or gas. The business can earn a rate of return on these assets that reflects efficient financing practices and costs.

The rate of return is fundamental in the capital-intensive industry of electricity and gas networks. The return on investment can make up approximately 50 per cent of revenue needs for network businesses.

What's in the rate of return guideline?

We must determine a rate of return that achieves the new rate of return objective—for the overall rate of return to correspond to the efficient financing costs of a benchmark efficient business.

Our draft rate of return guideline sets out what we mean by a benchmark efficient business and how we propose to calculate the allowed rate of return.

Our new approach will allow us to determine rates of return over time that are consistent with market conditions and in the long term interests of consumers.

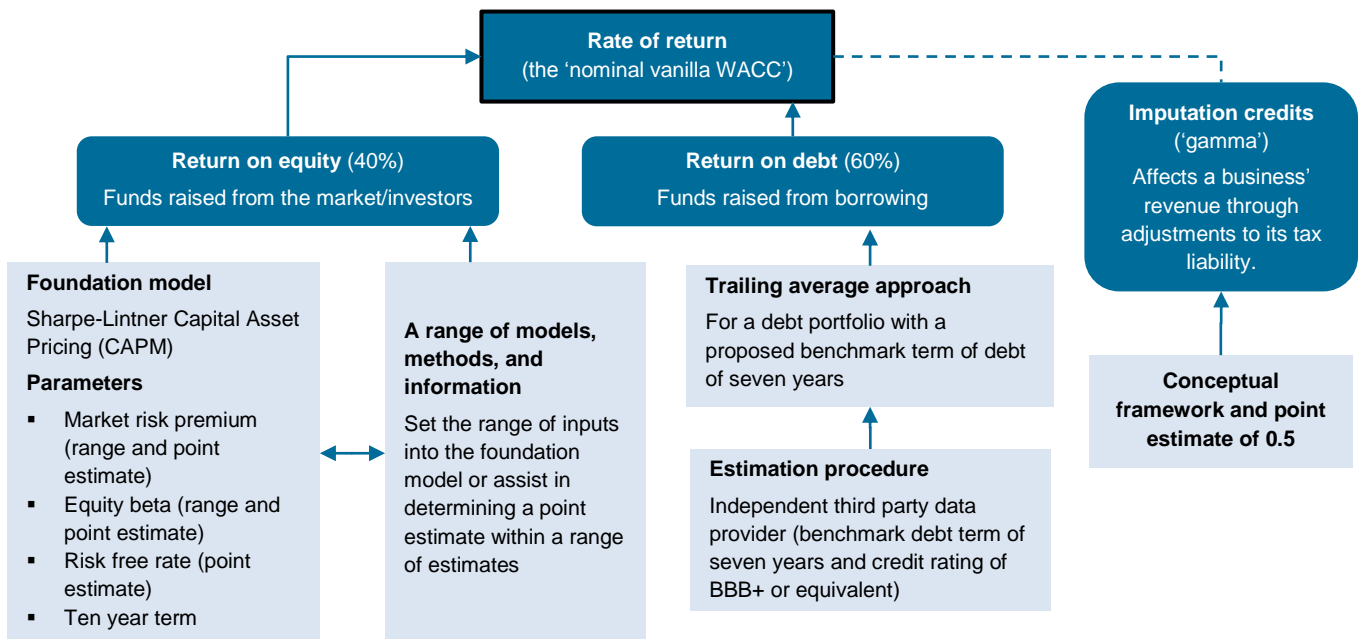
We set out the process we'll use to calculate the return on equity and the return on debt—the two main components to determining the rate of return. We also set out our reasons for setting the value for imputation credits (also known as 'gamma') to 0.5. Imputation credits are not related to the rate of return but affect a business' revenue through adjustments to its tax liability.

What's the benchmark efficient business?

We set the rate of return by considering the costs that a benchmark efficient business would likely incur. We define the benchmark efficient business as one whose only activity is providing electricity or gas network services (also known as 'pure play') and is regulated and operating within Australia.

We propose a single benchmark for all gas and electricity network businesses. We consider the risks facing electricity and gas networks are sufficiently similar such that a single benchmark is appropriate.

Overview of the rate of return guideline



How will we estimate the return on equity?

We will build on our existing approach in a way that gives greater consideration to the results of other models and information. We recognise there is not one perfect model. Rather, there are a range of financial models which all have certain strengths and weaknesses.

Our starting point will be the Sharpe-Lintner Capital Asset Pricing (CAPM) model. This is a widely accepted and understood financial model in the industry.

We will then use a range of models, methods, and information to inform our return on equity estimate, to:

- Set the range of inputs into the CAPM foundation model.
- Assist in determining a point estimate within a range of estimates at the overall return on equity level. For example, estimates from valuation reports, brokers, other regulators and alternative financial models.

The draft guideline also outlines some detail on our approaches to the market risk premium, equity beta, and risk free rate—which all inform the return on equity.

Our approach to the return on equity is flexible and will allow us to consider a broad range of information to determine an equity estimate consistent with the rate of return objective. We expect the application of our approach to lead to a more stable return on equity estimate over time.

How will we estimate the return on debt?

We propose to move to a trailing average for a debt portfolio with a proposed benchmark term of debt of seven years—a significant change to the current regulatory framework.

The current 'on-the-day approach' assumes that businesses raise all their debt at the same time, once every five years. However, many businesses have different dates to maturity for their debt.

We are proposing a gradual transition from using the current approach to a trailing average approach. The trailing average portfolio approach assumes that one-seventh of the debt portfolio is refinanced every year. The transition will occur over a period of seven years and will apply to all businesses.

Our approach to the return on debt will more closely align with the efficient debt financing practices of regulated businesses. This should also lead to less volatile prices over time for consumers.

How can I provide a submission or comments?

We invite interested parties to make submissions or comments on our draft rate of return guideline. If you would like to have your say prior to us publishing the final guidelines, you have until close of business **11 October 2013** to get your submission or comments to us. You can find further details on how to provide your submission on our web page www.aer.gov.au/node/18859, or you can email us at rateofreturn@ aer.gov.au.

For more information

For more information or to get involved in the consultation processes for the Better Regulation program, please visit our website www.aer.gov.au/better-regulation-reform-program or email us at betterregulation@ aer.gov.au.