

AUSTRALIAN ENERGY REGULATOR – BETTER REGULATION PROGRAM

RATE OF RETURN GUIDELINES CONSULTATION PAPER

COMMENTS

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# Introduction

The Council of Small Business Australia (COSBOA) supports the need for better regulation in Australia, the Australian Energy Regulator’s (AERs) involvement in this and the efforts of the AER to engage with consumers (and their representatives) in a meaningful way on its Better Regulation Program (BRP). COSBOA also appreciates the opportunity to provide written and other input to the BRP, including through this submission.

This submission responds to the AER’s Consultation Paper, *Rate of Return Guidelines* released in May 2013.

## About COSBOA and Energy Regulation

COSBOA was founded in 1979 and has a proud history of strong advocacy on small business issues ranging from taxation and workplace relations, through to competition law and retail tenancy. We were created by people who believed that small business needed a voice exclusively representing their interests. Our goals are to:

* Promote and support the development of small businesses in Australia;
* Advocate to advance the interests of small business in Australia, including through policy and regulatory reform; and
* Foster an increased awareness and understanding of the role of small business in Australia amongst elected government and officials, regulators, larger businesses, the media and the general community.

We engage our members and provide opportunities for them to influence outcomes affecting their business, and their industry. We also act as a conduit for information from our members to Government and other organisations, and vice versa.

Small businesses often do not have the time, the resources and the expertise required to be alert to the myriad of legislative and regulatory changes that affect them. COSBOA’s efforts are focussed on providing accurate and timely input into decisions which affect small businesses. Our members provide essential input to ensure the quality and relevance of our representation, as well as the substance and the credibility to back it up.

It would be fair to say that energy issues, including the regulation of monopoly network services, are an area containing much detail where small businesses can be significantly affected by decisions they know little about. The recent very large increases in electricity (and more latterly gas) prices would be a case in point.

A list of COSBOA’s members is shown in the Attachment to this submission. As can be seen they are broad ranging in terms of the industry they are part of or scope of their activities, provide national coverage and are all small business oriented. This provides important background to our involvement in the BRP.

## COSBOA’s Involvement in the AER’s Better Regulation Program

COSBOA is taking an active and broad-ranging interest in the AER’s BRP on behalf of Australian small businesses and has recently secured funding for this from the Consumer Advocacy Panel. The decision by the Panel to provide funding to support our work considerably boosts COSBOA’s ability to participate effectively in the BRP. Our involvement includes written submissions on all areas of the BRP that are important to small business and also participation in the AER’s Consumer Reference Group. However, this funding has only recently been secured and we are therefore endeavouring to respond as expeditiously as possible to a number of papers previously released by the AER, including the Rate of Return Consultation Paper.

## The Rate of Return for Energy Networks and Small Business

We note the AER’s comment in its Consultation Paper that:

“The return on capital often represents the largest component of the revenue determinations of service providers. A service provider should be provided with a reasonable opportunity to recover at least the efficient costs it incurs in providing regulated services and complying with a regulatory obligation or requirement or making a regulatory payment. The allowed rate of return allows service providers to obtain necessary funds from capital markets to fund capital investments and service the debt they incur in borrowing the funds. Therefore, the rate of return is a key element of the network charges that consumers pay.” (p. 11)

And support its further comments that:

“Service providers should be compensated for efficiently incurred costs and for the return required by their investors. However, allowed revenue should not be set in manner that allows for over recovery of these costs and returns.” (p. 12)

…

“ … consumers [should] pay no more than necessary for a safe and reliable supply of gas and electricity.” (p. 16)

As we understand it, the rate of return provided to electricity and gas networks as part of the AER’s regulatory determinations can be responsible for between 30-70 per cent of the revenue earned by these networks, and for a similar proportion of their prices.

As network charges account for about half of the delivered cost of electricity (slightly less for gas), this means that the rate of return can be responsible for up to one-third of the prices paid by consumers for their electricity and gas. This includes small business.

This immediately shows why determination of the rate of return for energy networks is so important to consumers. For consumers, including small business, it is imperative that the AER set a rate of return which is not excessive but ensures a continuing reliable and secure transportation of electricity and gas to their premises.

COSBOA does not believe that this has always been the case in the past as rates of return have been provided to electricity and gas networks that are excessively generous and this has fed into the recent large increases in network charges, which have in turn, been the main contributor to rising electricity and gas prices. We are particularly concerned that the determination of rates of return by Australian regulators through the process of setting a Weighted Average Cost of Capital (WACC) has:

* Become more and more complex and convoluted, dominated by arcane arguments that ordinary consumers have little hope of understanding, notwithstanding the importance of the rate of return to their energy prices. As a consequence, the rate of return has been made out to be a matter of ‘science’ dominated by the networks, regulators, consultants and lawyers, when it has actually evolved into more like an ‘art’ to be practiced by networks with the goal of obtaining as high a rate of return as possible by marshalling arguments and experts to support their case.[[1]](#footnote-1) Part of this also turns on the role of the Australian Competition Tribunal in reviewing AER determinations on appeal. We note that the Tribunal has often been required to adjudicate on rate of return matters raised by the networks in appealing AER determinations and that it has often upheld these appeals with devastating effects on network prices.[[2]](#footnote-2) This is not the time or place to go into detail on this, but we believe that these appeals have themselves been a consequence of the very detailed and convoluted process in place for determining the WACC.[[3]](#footnote-3) In other words, the process is being manipulated and strategically used for the benefit of the networks, not to meet the National Electricity and Gas Objectives (NEO and NGO) or the Rate of Return Principles (RRP). This has not assisted the goal, which forms part of the AER’s BRP, of consumers become involved in the regulatory process. We believe that the AER needs to consider this in developing its rate of return guideline.
* Resulted in the setting of some parameters which input into the WACC being excessive and responsible for an excessive rate of return being provided to the networks.[[4]](#footnote-4) We mention, in particular, the return on equity, return on debt, market risk premium and imputation credits. Obviously, a consequence has been electricity and gas network prices that are higher than they should be, not a desirable outcome and even less so at a time when energy prices are under extreme upward pressure in any case. COSBOA believes that these outcomes have been due to a combination of poor rules under the National Electricity and Gas Laws (NEL and NGL), the overly complex determination of the WACC (which has played into the hands of the regulated networks given their core interests and significant resources) and the shortcomings in the appeals mechanism. We observe that the Australian Energy Market Commission (AEMC) has made changes to the rules for both electricity and gas, which should help to deal with some of the problems in that area and that the Yarrow Review has recommended significant changes to improve the operation of the appeals mechanism. We believe that the AER needs to ensure that its Rate of Return Guideline also contributes towards limiting the complexity and detail involved in determining the WACC and in ensuring that the key WACC parameters are set in a way that provides fairer outcomes to consumers and ones that better match the NEO, NGO and RRPs. We acknowledge that the AER’s Consultation Paper aims to do this in terms of its approach to the setting of the WACC but remain concerned that the Paper seems to increase complexity in a number of ways rather than reduce it.[[5]](#footnote-5)

COSBOA wishes to draw the AER’s attention to the fact that small business in Australia is under significant pressure at the moment and faces a difficult business climate. This includes rising costs which they find difficult to pass on. A significant factor is the very large increases in electricity prices seen over recent years, especially network charges, which have nearly doubled in some jurisdictions in the space of 4-5 years. Given the importance of the rate of return to network prices, the AER’s BRP needs to ensure that rates of return for networks do not contribute to excessive network prices in future.

## Rate of Return Framework and AER’s Rate of Return Issues Paper

COSBOA have not yet had an opportunity to comment on the Rate of Return framework or the AER’s *Better Regulation: Rate of Return Issues Paper* released in December 2012 so we take that opportunity here and to provide some additional context to our subsequent comments on the Consultation Paper.

* We support that the AER should have a greater degree of discretion in determining the rate of return, including the methods it uses to do so, provided that it uses this wisely, with the long term interests of consumers at front of mind and does so transparently with reasons set out clearly. We note the AER’s stated intension to do this, including its proposal to use a set of criteria to apply to how it exercises regulatory judgement.
* We support that the regulation of energy networks should provide incentives that are comparable to those faced by firms in other parts of the economy, especially those operating in competitive markets, noting that to do otherwise would not promote economic efficiency and would not be in the long term interests of consumers.
* We support that the AER develop a guideline setting out how they will approach determining the allowed rate of return for electricity and gas networks. We note that the guideline will not be binding on either the AER or networks but that reasons will need to be provided for departing from it and believe that there should be sound, transparent and unusual circumstances to depart from it. We further support that an aim should be to limit future changes in the guideline to incremental ones, noting the extensive consultation taking place around this initial guideline, unless there are clear deficiencies or major developments (such as in regulatory practice), which require more substantial changes and that any changes be subject to multi-stage consultation, including with consumers.
* We support that the AER apply a principles based approach to the rate of return guideline and that the principles should be anchored to the NEO, NGO and RRPs, particularly the long terms interests of consumers. However, as mentioned above, we are concerned that in the past the allowed rates of return for energy networks have been excessive and it will be important for the AER’s rate of return guideline to avoid this in future.
* Bearing the above in mind, development of the guideline should consider application of all relevant estimation methods including financial models, market data and other evidence. COSBOA notes the comment s in Section 2.3 of the Consultation Paper regarding how the AER intends to interpret these terms and generally supports the approach outlined. However, we believe that any estimation method has strengths and weaknesses and that its use in determining the rate of return should keep this in mind. This suggests a need to be prepared to use other techniques available to the AER, as a minimum, to provide cross checks and reasonableness checks bearing in mind the NEO, NGO and RRPs. This is consistent with what the AER appears to have in mind.
* In Section 2.4 of the Consultation Paper, the AER sets out its proposal to use ‘criteria’, rather than ‘principles’ or ‘considerations’ (as proposed by the energy networks), to make judgements about how it estimates the allowed rate of return. COSBOA does not oppose this provided these criteria clearly relate back to the NEO, NGO and RRPs and are subordinate to the NEL, NGL and associated rules. In this regard, we note the AER’s comment that:

“We will use these criteria to assess whether information and data presented to us is appropriate and relevant for making decisions on the rate of return. We will use the criteria to give weight to data that is deemed relevant for estimating the allowed rate of return and ensure that we are meeting the national electricity objective. Data and other evidence that meets only some of the criteria may be given less weight or have no weight placed on it. The criteria will therefore help us to make regulatory judgements in respect of meeting the rate of return objective.” (p. 30)

We have also considered the proposed criteria set out at the end of Section 2.4 and believe they provide a good basis for the exercise of this judgement by the AER.

The remainder of this submission responds to the AER’s Consultation Paper.

# COSBOA’s Responses to Consultation Paper Issues

In this section we provide our responses to the AER’s *Rate of Return Guideline Consultation Paper*. The follows the same order as the Consultation Paper.

## Overall Rate of Return

Below we respond to Section 3 and Questions 3.1 to 3.6 of the Consultation Paper. We also consider Appendix D and relevant parts of Appendix G.

### Continued use of WACC Formula and Point Estimates

The AER propose to continue to use the WACC formula plus point estimates of the return on equity, return on debt and gearing ratio.

We have no objection to the AER continuing to use the WACC formula provided that consideration is given to ensuring that the overall WACC number and its individual parameters are reasonable and do not provide the network businesses with excess revenue (we raised some concerns regarding this earlier in this submission).

We also do not object to the continued use of point estimates of the overall rate of return, and the returns on equity and debt provided these are subjected to checks to ensure the reasonableness of the point estimates and adjusted as necessary where this is not the case. We believe that the publication of ranges can also be informative, including to consumers.

We would also strongly suggest the use of comparisons of rates of return adopted here and overseas as an additional check to be applied at the overall level. We note the AER’s comments that these can be based on different approaches to establishing the rate of return, different markets and different conditions, but believe that the AER should seek to normalise this information and also raise with other regulators – here and overseas – that a project be established to undertake comparisons of rates of return based on consistent measurements.

The AER comments that it believes that using data on actual rates of return earned by the networks may be due to outperformance of the benchmark return set in the regulatory process and would not necessarily imply an excessive rate of return. Whilst we agree with the importance of networks being incentivised to outperform their benchmark, we note that some recourse to actual returns can still provide useful information to check the veracity of the allowed rate of return, e.g. significant levels of outperformance may be indicative of excessive returns, and should not be excluded from consideration.

### Reasonableness Checks of the Overall Rate of Return

COSBOA supports the use of reasonableness checks to help determine the need to re-examine the overall rate of return, return on equity, return on debt and the gearing ratio. We have considered the various checks listed in Section 3.5.22 of the Consultation Paper and discussed in more detail in Appendix D, including their limitations. Notwithstanding these limitations, we agree with the AER that the use of such checks can still be valuable in setting the rate of return and key parameters, provided these limitations are kept in mind. As alluded to above, we believe that the AER should also consider overseas evidence of rates of return, including from other regulators, in assessing reasonableness.

In relation to the use of Regulatory Asset Base (RAB) multiples, we are concerned by the AER’s comment that:

“Regulated asset sales do, however, provide a useful real-world indication of whether market participants consider our benchmark WACC to be, broadly speaking, reasonable. The consistent positive trend as discussed below provides evidence that our WACC approach has not been unreasonable.” (p. 111)

The evidence presented in Table D-1, in fact, shows that RAB multiples for those acquisitions considered have been well above unity for four out of the six shown, i.e., that the market value was above the book value. This seems to suggest, *prima facie*, that the regulatory rate of return was above that required by investors, noting that a range of other factors may have also contributed to this outcome. The AER’s conclusion seems to be based more on a consideration of what has “not been unreasonable” more from the perspective of network owners rather than consumers? If the AER has other evidence for this conclusion it would be helpful if it were set out more clearly.

We have a similar concern in relation to the comments in the Consultation Paper on the use of trading multiples and the evidence presented therein, which consistently shows trading multiples well in excess of unity.

The Consultation Paper also presents information in Table D-6 on the rates of return set by other regulators in Australia for a range of utilities and says that the AER “did not agree with proposals which stated that there is circularity in considering our recent decisions against our current decision. Rather recent decisions are more likely to reflect similar market conditions.” (p. 122) We find this a rather narrow conclusion as the evidence presented does not rule out a circulatory issue. One matter that concerns us is the well known tendency for Australian regulators to follow precedents set by each other and to readily accept Tribunal decisions, which might be due to circularity not to similar market conditions.

We have noted the AER’s comments in relation to the possible application of a financeability test. Given the RRP’s objective that the AER sets the rate of return required by a benchmark efficient service provider, with similar risk characteristics as the service provider subject to the decision, in its provision of regulated services and return on capital commensurate with the efficient financing costs of a benchmark efficient service provider, given that it applies a number of reasonableness metrics to confirm the rate of return and that it can apply credit metrics to check on the reasonableness of its decision, we see little point in also applying a financeability test. We would be even more concerned if such a test came to be used, or was sought to be sued by the networks, to prop up existing operations and ownership structures.

### Term of the Return on Equity

We note that the AER currently applies a ten year term to the return on equity (and the return on debt), presumably on the basis that this more closely matches the long lived assets that characterise energy networks, whereas the regulatory period is typically shorter at five years. We also note the some regulators use a ten year approach and others five years. Lally’s advice is that the present value principle[[6]](#footnote-6) is fundamental to economic regulation as it both promotes efficient investment and avoids excess profits. We note the comment in the Consultation Paper that his recent position is that use should be made of a term for the risk free rate (a component of the return on equity) that is consistent with the regulatory period, i.e., five years. In the absence of information to the contrary, COSBOA would be inclined to follow Lally’s advice.

### Approach to and Term of the Return on Debt

COSBOA notes that the AER currently applies an ‘on the day’ approach[[7]](#footnote-7) to estimating the required return on debt and also the comments it has received that this is not an accurate reflection of how network businesses actually source debt and could be distorting their decisions. The AER has suggested that the use of an average return[[8]](#footnote-8) or a hybrid of the two approaches could also be used. However, we note that there could be tensions and trade-offs involved in selecting an approach and a five or ten year period for establishing the return on debt. We have also taken into consideration the concerns expressed by the AER about the transition issues in moving from one approach to another. In particular, we would be concerned if adopting a portfolio approach coincided with a period in which trailing average returns on debt were higher than ‘on the day’ returns and this pushed up network prices. We support the AER comment that:

“If we judge a portfolio approach to be preferable on economic grounds, we will need to convince ourselves that making the change is likely to be in the long-term interest of consumers, particularly if the short-term impact may be higher energy prices at the next set of determinations than under the “on the day” approach. (Consultation Paper, p. 80)

Though we might be inclined to support a five year period, we seek further information and guidance from the AER on this and the approach to be used.

We note the comments in the Consultation Paper about the use, by the ERA, of the ‘bond yield approach’ to establishing the debt risk premium and that this obviates the need for the return on debt to be specified as it is an output from this model. This seems to have some attractions but it is difficult to be definitive on this based on the brief discussion in the Consultation Paper. It would be useful for the AER to provide more information on this.

### Point Estimates and Ranges

COSBOA’s current position on these matters is set out below:

* As stated above, we support the adoption of a point estimate for the overall rate of return provided this is informed by reasonableness checks as proposed.
* We support the AER’s proposal to use a single point estimate of the return on equity, possibly from within a range determined by multiple models and/or parameter ranges.
* Similarly, we support the use of a single point estimate for the return on debt, with reasonableness checks, but remain undecided on the approach (model) to use.
* In relation to the other WACC parameters, we have carefully considered the discussion of this in the Consultation Paper and noted the divergence in approaches by regulators. Given the lack of any settled view, we would seek further information and guidance on it from the AER.
* We also note the AER’s comments on the use of ranges and the higher degree of regulatory judgement involved in their use. Whilst we would normally favour greater accuracy and point estimates, we also recognise that this may not always be possible or desirable. Hence, we recognise the trade-offs involved in such decisions. Where it is decided that the best overall approach is to make partial or total use of ranges, the reasons for this should be clearly set out for all to see and the exercise of judgement by the AER on its use of ranges should be made transparent.

### Intra-period Adjustments

COSBOA has considered the AER’s discussion of the possibility of making adjustments to the return on equity and the return on debt within regulatory periods (or providing a ‘true-up’ mechanism for this in the next regulatory period).

In relation to the return on equity, the AER proposes to maintain its current approach of setting this for the entire regulatory period on the basis that the rules do not explicitly provide for annual adjustments and no stakeholders commented on it. Whilst we might be inclined to support this, it would nevertheless be useful for the AER to set out the arguments. We also query whether annual adjustments would be consistent with the regulatory objective of setting rates of return for the networks that provide longer term incentives for them to operate efficiently and manage risks efficiently?

On the return on debt, we have taken into consideration the AER’s comments regarding the advantages and disadvantages of annual versus whole of period approaches. Without knowing more about how these will impact on the regulatory outcomes it is difficult for us to form a definite position on this matter. We would therefore welcome further discussion on it.

We also note the AER’s comments in relation to its possible development of an in-house data base to determine the cost of debt and how this could be complicated by the additional need for annual adjustments in the return on debt. COSBOA believes that the development of such a data set could be useful, particularly if it leads to overall improvements in the determination of the cost of debt.

## Benchmark Firm and Risk

Below we respond to Section 4 and Questions 4.1 to 4.3 of the Consultation Paper.

COSBOA supports the allowed rate of return objective that the rate of return for a network is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to a network business in respect of its regulated network services. We also support that the AER need to identify the degree of risk to which the network is exposed in providing regulated services, and identify what the efficient financing costs of an efficient benchmark entity would be in this context.

We also support that the context for the AER to consider this is for an investor or lender who faces a broad range of investment opportunities, which may be domestic or international.[[9]](#footnote-9)

### Types of Risk

The Consultation Paper raises the issue of whether certain types of network could be subject to different levels of risk. We note that the regulated networks exist in a low risk environment given considerations such as: they are mature industries and technologies; they are monopolies; they exist behind a ‘shield’ of regulation; they are more insulated from economic fluctuations, and demand for their services is inelastic with respect to price changes. Also relevant is the consideration of whether the risk is related to the return on equity, return on debt or gearing, and whether it should be compensated through the rate of return or otherwise (e.g., through the expenditure allowances).

Many electricity networks regulated by the AER are also government-owned and therefore subject to even less risk (with lower costs of finance), a matter which we believe is relevant to the AER’s consideration and which currently results in rates of return for networks in those states being higher than their costs of risk reflect. Consumers in those states pay significantly higher network prices as a result.

The Consultation Paper provides a long list of factors that may be relevant to consider in establishing risk. We comment on these below:

* *Demand risk*: this is not an issue for networks regulated under a revenue cap; for those under a price cap, it may be relevant but is a two-way risk that can also reward firms through operation of the incentive structure, and may already be considered elsewhere in the regulatory regime.
* *Delivery risk*: seems to us to include matters related to appropriate management by the firm and for networks these costs may be subject to roll-forward into the RAB in the next regulatory period; again the risks/costs can work both ways.
* *Input price risks*: compensation for such risks in the rate of return would seem to ignore the incentive powers provided in the expenditure incentives and works both ways.
* *Inflation risk*: service providers are protected from this type of risk through the ‘CPI-X’ formula.
* *Financial risk*: this is a two-sided risk that could also work in the firm’s favour and, to the extent that any downside risks are controlled by management, they should not be compensated.
* *Competition and new entry*: as monopolies, networks are insulated from this risk, particularly for their regulated services; if they are subject to such risks in non-regulated areas, this should be excluded from their regulated activities; and the current use made of demand management and distributed generation is limited and therefore represents little threat to their regulated activities (they may also benefit from trends in this direction, though the introduction of schemes such as the DMEGCIS).
* *Size and scope of operations*: this may be relevant but its materiality and measurability would need to be established.
* *Stranding*: networks are already well protected from this risk through other provisions in the regulatory regime such as the roll-forward of assets into the RAB; competitive firms have to bear these risks.
* *Political and regulatory risk*: to our knowledge, networks have often sought, and been granted, compensation for such changes through means such as cost pass-throughs or additional expenditures.

Other factors raised in submissions on the Issues Paper include that gas transmission networks face greater risks, that risks may reduce with the size of the RAB, that the customer base and location may be relevant and even that the choice of model used to estimate the return on equity could be relevant. Whether these types of risks are relevant to consider is a matter for argument, but we believe that it would be impractical (and probably undesirable from the standpoint of establishing a benchmark) to differentiate on all manner of factors in determining risk and that, where differentiation is desirable, it must still be material and measurable.

As a more general comment, we note that networks already receive a range of substantial compensations for risk through mechanisms such as pass- throughs and contingent projects. If they believe that there are other risks not currently compensated for it is up to them to raise them in these contexts during their determinations. This also makes the acceptance and costs of such risks more transparent, including to consumers.

It would also be relevant for the AER to consider ways in which the networks may currently be overcompensated for any risks they do not face.

### Benchmark Efficient Entity

COSBOA supports that the AER should:

* Maintain an approach which places significant weight on the use of a benchmark efficient entity that is “similar” to the regulated network in terms of risk. To do otherwise would be inconsistent with the NEO and NGO, the objectives of incentive regulation and the rate of return objectives, would be needlessly complicated, and would lack transparency. We therefore agree that any differences in risk considered should be material.
* Only consider risks that are relevant to regulated services.
* Maintain a simple rather than complex approach involving as few benchmarks as possible. We believe that this will also assist understanding by and engagement with consumers in future regulatory determinations, including with small business.

## Return on Equity

Below we respond to Section 5 and Questions 5.1 to 5.4 of the Consultation Paper. We note that the AER intends to provide additional guidance on its approach to determining the return on equity, including the models its uses, in the draft and final guidelines. Nevertheless, we offer our preliminary comments based on the discussion and views sought in Appendix E to the Consultation Paper.

### Determining a Single Point Estimate

The AER has proposed four broad approaches to determining a single point estimate of the return on equity:

1. A single model.
2. One primary model with reasonableness checks.
3. Several primary models with fixed weights
4. Multiple-models combined with other information.

COSBOA has considered the strengths and weaknesses of each of these approaches in the context of the likely outcomes produced by the models and its preference for a simpler rather than complicated approach. On this basis, we would see advantages in approach 3, which allows for quantifiable, but simple, weights to be applied to the assessment of an estimate. We would also seek that reasonableness checks be applied in this approach. However, we have also taken into account the AER’s comment that “at this point no stakeholders have been able to clearly explain how the various information sources can be brought together transparently.” (Consultation Paper, p. 64) If this remains the case, we would prefer approach 2. It would be preferable to use this approach rather than rely on inappropriate or uncertain weights in the application of multiple models. We also note and support the AER’s comment that “the use of regulatory judgment [in the application of this approach] must be well reasoned.” (Consultation Paper, p. 64)

### Stability

COSBOA has considered the comments in the Consultation Paper about stability, particularly the impact that a stable return on equity would have in smoothing network price fluctuations. We recognise that price stability may be valued by energy consumers, including small business, and that the volatility of network prices seen in recent years has created angst among our members. However, this is more due to the factors such as very large increases in expenditures allowed by the AER and decisions by the Australian Competition Tribunal, rather than instability in the return on equity due to the AER’s current approach. Whilst we would place some weight on stability in the return on equity, if this came at a cost, e.g., a generally higher return on equity and higher network prices, then the value of stability would diminish. Some further information from the AER (e.g., some empirical evidence showing likely outcomes) would be welcomed by COSBOA.

### Different Models in Different Circumstances?

We have taken note of the discussion in the Consultation Paper on this issue and consider that the impracticalities, imprecision and complexities of applying different models to different circumstances (e.g., industry, firm and market conditions) are not attractive to small business. We note the AER’s intension to make its assessment of different models in the guideline and use this to assess how they will be used.

### Determining the Return on Equity for the Average Firm

COSBOA agrees with the AER that there is no benefit in determining this.

### Models

COSBOA notes and concurs with view expressed by other stakeholders and outlined in the Consultation Paper that all financial models have shortcomings, that none are perfect, that all will provide different outcomes and that, as a consequence, if would be preferable to recognise this and not have to rely on any one model. However, we further note that, based on the discussion in the Consultation Paper, some are clearly to be preferred over others and we believe that this should provide important guidance as to the choice of model(s) used by the AER. As mentioned above, we also believe that it is possible to choose a primary model and use one or more others to provide a reality check on results obtained from the primary model, so long as there is reasonable consistency between them and the exercise of judgement by the AER is clearly set out.

Based mainly on the discussion in Appendix E of the Consultation Paper, we offer the following brief assessment of each model discussed therein.

#### Sharpe-Lintner CAPM

Whilst this model has some known shortcomings and its use to date has been partly due to a requirement in the NERs, it also has some advantages such as soundness in theory, empirical useability, relatively robust, well established and widely accepted input parameters and widespread use. We note also the AER’s comment that one of the claimed shortcomings has arisen from flawed testing methods rather than theoretical deficiencies. On this basis, we believe that there are sound reasons to continue to use this model as either a primary or secondary one. However, we have some concerns that the model produces volatility on estimation of the return on equity out of proportion to actuality. This needs to be taken into account and additional checks applied.

#### Black CAPM

We note with some concern the recent advice to the AER that this model is not well accepted, does not have robust parameter inputs and that estimates of the zero-beta parameter are highly variable. We also note that the model produces generally higher estimates than Sharpe-Lintner for values of the return on equity below one (the relevant range for AER determinations) resulting in higher network prices. To the extent this model is used, its shortcomings would need to be made explicit and recognised in AER decisions.

#### Intertemporal CAPM

We have taken note of the AER’s assessment that the predictive power of this model has not been substantiated and that it did not offer demonstrably better estimates than the Sharpe-Lintner CAPM. We also note that no-one has proposed the use of this model. On this basis, we would discount its use unless circumstances change.

#### Dividend Growth Models

COSBOA has considered the comments on this model. We note that the AER has suggested that it has some advantages and can be used to generate estimates of the return on equity for the market (which provides an estimate of the Market Risk Premium and the return on equity for regulated businesses). However, we also consider that the AER’s concerns about the model, i.e., that its estimates were contentious and not able to be accurately modelled for Australia, due to limited and small data sets, and variability in the estimates produced, could be significant issues in its application. Nevertheless, this model appears to have some attractions, was supported by stakeholders and should be assessed more fully by the AER in developing its draft guideline.

#### Fama-French Three Factor Model

We note the assessment that the AER has recently undertaken of this model, which concluded that it should not be accepted because it was not well accepted, did not have a strong theoretical basis, was not supported in the literature and showed conflicting evidence in US studies. On this basis, the model would seem to have a limited basis for acceptance.

### Sharpe-Lintner CAPM Parameters

Below we comment on issues raised by the AER in regards to its use of the Sharpe-Lintner CAPM model in Appendix F of the Consultation Paper.

#### Model Form

Using the discussion in Appendix F as a basis, we believe that the existing ‘partially integrated’ form used by the AER is the most appropriate. Other forms are both more complex and imprecise, or do not conform to the reality of the Australian market, which includes both domestic and international investors.

#### Risk free rate

Whilst COSBA agrees with many of the comments made by the AER in regard to the risk free rate, we believe that the use of a five year Commonwealth Government Security would conform to the regulatory period, would still have most of the characteristics mentioned and that consideration could be given to using a longer averaging period to iron out fluctuations (see also our earlier comments in Section 2.1.3).

#### Market Risk Premium

We have taken note of the AER’s reasons for adopting a Market Risk Premium (MRP) of 6.0 per cent in the past, but note that historical averages, including those provided in Appendix F, suggest that 6.0 per cent is at the high end of the MRP’s range, which works to the advantage of network businesses. We note also that the Consultation Paper presents expert views suggesting that historical averages seem to provide the best estimates. On this basis, we would support the adoption of unconditional mean MRP supported by triangulation and reasonableness checks using alternative approaches. We can see little justification for adopting a higher MRP than 6.0 per cent, but believe there are some reasons to lower it.

#### Equity Beta

We have commented earlier in this submission on issues relevant to this. In relation to the de-levering/re-levering question, based on commentary on this in the Consultation Paper, COSBOA believes that it is relevant that the AER’s current approach, whilst not strictly correct in its zero debt-beta assumption, is unlikely to lead to any material error given the insignificance of the leverage difference.

On the question of removing outliers such as the ‘technology bubble’ and GFC from the estimation period, we note the AER’s comment that the ‘technology bubble’ is becoming a less significant influence as time goes by. On the GFC, we are reluctant to comment definitively on its treatment as an outlier without the benefit of more information, but note that it continues to affect markets. How permanent this is remains an open question, but it is difficult to imagine that markets will not return to a ‘normal’ state at some time in the future. One question is whether this is the historical norm or some new future norm?

On the question of using data on foreign businesses, we support the continuation of this to help determine the benchmark. We note that the AER currently assigns these less weight due to differences in regulation and market conditions. However, this appears to lack transparency. It would be preferable if a way could be found, perhaps in co-operation with relevant regulators, to adjust the data to take account of differences. We also would support the inclusion of listed foreign water utilities (and other utilities with similar characteristics and regulatory regimes to electricity and gas networks) noting the supportive comments for this from Bishop and Officer.

## Return on Debt

This covers Section 6 and Questions 6.1 to 6.2 of the Consultation Paper and also Appendix G and Questions G.1 to G.5. We have covered relevant aspects in our earlier comments on the Overall Rate of Return (see Section 2.1.4).

## Gearing

This relates to Section 6.7, Appendix G.4 and Questions 6.3 and G.6 of the Consultation Paper.

 The AER is proposing to continue to use the 60 per cent level of gearing that it currently applies and compare this to “a variety of methods to calculate the gearing of a comparator sample of businesses.” (Consultation Paper, p. 177)

* However, the AER does not present evidence in support of the 60 per cent level other than to refer to its 2009 WACC review. It would be helpful if the AER could discuss in more detail the evidence in support of this level. One particular concern is that it appears that it is not unusual for networks to have gearing levels significantly higher than this.
* The AER also proposes to use the same quantitative evidence as emerged from the 2009 WACC review. We have examined this list and it seems to us to be appropriate. However, we note the need for the AER to transparently set out how it uses these data and what conclusions in relation to gearing levels it draws from this.

## Imputation Credits

This covers Section 7 and Questions 7.1 and 7.2 of the Consultation Paper and also Appendix G.

### AER’s Propositions on Gamma

In making our comments, we note that the AER intends to undertake a detailed technical review of the individual gamma estimates in the draft guideline and has therefore restricted issues in the Consultation Paper to conceptual ones. It raises four matters in Section 7.4:

* *Should the AER rely on a definitive source of evidence or consider a range of sources*

Noting the contention that exists around the value of gamma, the variation in values used by different regulators and the decision of the Australian Competition Tribunal to significantly lower the AER’s preferred value of gamma, we believe that it could well be useful to consider a range of sources. However, this would need to have regards the strengths and weaknesses of each, the risk that these sources may themselves display variation in the value of gamma; and a position would need to be taken on how to use the different sources and how much weight to put on them (and how to assign weightings). We believe that the AER should consider these matters further and apprise stakeholders of the outcome.

* *Should the AER use the market value or face value of imputation credits?*

We note that conceptually these two measures are quite different and this immediately raises an issue. We also note that the AER has remarked that the question it raises has no definitive answer and that the Tribunal has not yet opined on it. This creates a difficult set of circumstances and we suggest that further investigation and consideration may be beneficial in working through the issue. We note that the AER has alluded to the use of both values but we do not yet have a good sense as to what issues this might raise, e.g., how to surmount the issues that neither one is definitively correct, that conceptual or practical inconsistency exists, and of how much weight to place on each. On the basis of the information presented in the Consultation Paper, we cannot come to a definitive position.

* *Should the AER consider tax studies (average investor preferences) or dividend drop off studies (marginal investor preferences)?*

The AER has raised the possibility of considering both where there are distinct trading preferences and this may offer a decision path. We note that the AER is undertaking further work to improve understanding of tax statistics and their use in estimating the utilisation rate as a gamma parameter. Considering comments in Appendix H on the problems associated with the use of dividend drop off studies to estimate the utilisation rate, it would be helpful if the AER could provide further guidance to stakeholders on the impact of these in estimation and how this would affect their use.

* *Should the AER use gamma estimates for the whole economy or a narrower base?*

We comment on this below in Section 2.6.3.

We believe it is also be useful to consider consistency with the NEO, NGO and RRP and the Rate of Return criteria in considering all questions about the estimation of gamma and note that in Appendix H the AER says it will be doing this. Given the conceptual and practical difficulties that arise in setting gamma, we recognise that the AER will need to exercise some regulatory judgement and note its comment in Appendix H that it will do so in as robust and transparent a manner as possible.

### Stability of Gamma

We have taken note of the AER’s comments on this, including that the value of gamma can be affected by a variety of changes, that these changes can take time to identify and account for, and that re-estimation is complex and resource intensive. From this that AER has concluded that it expects gamma to remain relatively stable over time but that it will consider new evidence as it becomes available. COSBOA appreciates the position of the AER on this matter, but expects that the AER will do all that is necessary to ensure that the gamma estimates it uses in determination are both as robust and up-to-date as possible. This is important in terms of meeting the NEO and NGO.

### Monkhouse Formula and Gamma Parameters

COSBOA notes that this formula is a commonly used way to model gamma, but that it only focuses on a single year and therefore may not capture retained franking credits. We also note and welcome that the AER is undertaking further analysis on the form of an appropriate payout ratio. Bearing in mind the past disagreements over the value of this ratio, including the successful appeal to the Tribunal challenging the AER’s choice of 1.0, and potential issues in underlying calculations, we hope that this work will help to resolve some of these contentions.

As the current estimate of the gamma input parameters (pay out ratio and utilisation rate) are based on economy-wide data, the AER has raised the question of whether it should instead use a narrower benchmark, such as utilities or energy businesses, which could change the estimate. Intuitively it would seem to COSBOA that a choice of narrower benchmark based on utilities or energy networks would find that these pay higher dividends and franking credits relative to the rest of the economy, with a higher payout ratio.

We also note the AER’s comments that the choice of a narrower benchmark may require its adoption for the utilisation rate as well, but that this is more difficult to estimate. We note both that this may require a pragmatic approach and that the AER intends to adopt a holistic view across the two parameters having regard to the rate of return criteria.

Regarding the use of other types of approaches to estimating the utilisation rate mentioned in Appendix H, COSBOA suggest that there would be value in the AER considering these further to inform consultations about their possible use.

## Debt and Equity Raising Costs

This covers Section 8 and Question 8.1 of the Consultation Paper.

We have considered the AER’s proposal that it no longer include these costs in the building block revenue allowances but seek to include them in the rate of return calculation or the allowed expenditures. Based on the AER’s view that the current approach is complex, contentious and its evidence that the allowances are small, COSBOA agrees with the AER’s proposal. In terms of where to remunerate them, we would seek further information from the AER on the options it has raised.

Some submissions from the network side are also seeking to add liquidity and risk management costs to the allowance. However, the AER points out that there is no consensus on efficient practices in these areas, that risk management is a function of the firm’s shareholders preferences, that the AER would need to establish these costs and that data problems are likely to exist. These issues raise difficulties and COSBOA therefore does not agree with the submissions seeking to add these items to the AER’s allowances. We also suggest that such costs are likely to be even smaller than the actual costs.

## Forecast Inflation

COSBOA notes the various uses to which forecast inflation is put in the AER’s regulatory determinations, including maintaining the real value of cash flows. It therefore has a bearing on revenue allowances and network prices. Bearing in mind the discussion in the Consultation Paper, including on the recent history of changes in methodology and why, we support consideration of this matter in developing the AER guideline. However, our present position, subject to further consideration, is that we do not see valid reasons to change the current approach.

# ATTACHMENT: List of COASBOA Members

Australasian Association of Convenience Stores

Australian Booksellers Association

Australian Digital Television Association

Australian Equipment Lessors Association

Australian Hairdressing Council

Australian Human Resources Institute

Australian Livestock and Rural Transporter Association

**BPW Australia** (Australian Federation of Business and Professional Women)

Business Enterprise Centres Australia

CITT (Council of Information Technology & Telecommunications)

Commercial Asset Finance Brokers Association of Australia

Convenience and Mixed Business Association

Fitness Australia

FSV

Independent Retailers Organisation

Institute of Public Accountants

National Financial Services Federation

National Independent Retailers Association

Pharmacy Guild of Australia

Pittwater Business Limited

Real Estate Institute of Australia

Stocktakers Institute of Australia

Tasmanian Small Business Council

University of Western Sydney

1. We do not seek to question the network’s role in doing this as they are responding to incentives for them to do so, as would any commercial business. Rather, it is a matter of the signals which those incentives send to them and their appropriateness. [↑](#footnote-ref-1)
2. The Yarrow Review of the merits review appeals mechanism observed that WACC related appeals to the Tribunal have resulted in additional revenue to the networks involved of $3.3 billion and that these appeals had been the most lucrative ones for the networks. [↑](#footnote-ref-2)
3. We note that the Yarrow Review, which provided its Final Report to the Standing Council on Energy and Resources (SCER) in 2012, made recommendations that would improve the operation of the merits review process, although these have not yet been acted upon. [↑](#footnote-ref-3)
4. Including relative to those set by other Australian and overseas regulators. [↑](#footnote-ref-4)
5. In saying this, we recognise that the AER is seeking to improve its approach to the WACC and the WACC parameters, both conceptually and empirically, which we support, but this is not necessarily inconsistent with a goal of reducing complexity. [↑](#footnote-ref-5)
6. The present value of a network provider’s revenue stream should match the present value of its expenditure stream (plus or minus any efficiency rewards/penalties). [↑](#footnote-ref-6)
7. That is, the return that would be needed if the network sourced all its debt in a single parcel at, or just before, the date of the AER’s regulatory determination. [↑](#footnote-ref-7)
8. That required by debt providers if a benchmark efficient utility raised debt over an historical period prior to the commencement of a regulatory year within the overall regulatory period. [↑](#footnote-ref-8)
9. COSBOA notes that the AER has engaged consultants to assist it with these issues and that the Consultation Paper invites submissions to consider their advice. However, we are not aware of this advice having been published on the AER’s website. [↑](#footnote-ref-9)