AUSTRALIAN ENERGY REGULATOR – BETTER REGULATION PROGRAM

RETURN ON EQUITY ISSUES PAPER

COMMENTS

October 2013

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1 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 *Return on Equity Issues Paper* released in October 2013. We appreciate the considerable thinking, work and effort that have gone into producing this paper.

COSBOA has previously provided submissions on the AER's *Rate of Return Consultation Paper* and its Rate of Return Draft Guideline and *Explanatory Statement*.

Our comments in this submission are targeted at the proposal by the AER to set the return on equity and the reasons for its choice of its value at 0.7. We have strong objections to the AER's choice as it will lead to regulatory outcomes where network charges are significantly higher than they need to be. COSBOA does, however, accept that the available evidence presented in Issues Paper has led the AER to the conclusion that the return on equity for Network Service Providers (NSPs) is in the range 0.4 to 0.7. However, we note with concern the estimation in other submissions suggesting that the difference between a choice of 0.7 (the top of the return on equity range selected by the AER) and 0.4 (the bottom of the range selected) would provide NSPs in the National Electricity Market (NEM) with more than $600 million, or 5 per cent, in additional annual revenue. Given the limited justification for choosing the top of the range as the point estimate, we believe that the AER's proposal is not consistent with the National Electricity (Gas) Objective, that is, it is not in the long terms interests of consumers of electricity (gas) and not consistent with the rate of return objective.

The remainder of this submission outlines the reasons for our position and also briefly comments on some other matters in the Issues Paper. We also take this opportunity to apologise for this submission not being lodged by the deadline of 28 October 2013. The AER has been made aware of the reason for this through an email exchange with our consultants, and that it was unfortunately beyond our control.

A list of COSBOA members is attached to this submission.

2 Reasons for COSBOA's Concern about the AER's Proposed Return on Equity

This section outlines COSBOA's reasons for its concerns about the AER's proposed point estimate for the return on equity of 0.7.

2.1 Conceptual Evidence

We do not believe that the AER's choice of 0.7 is consistent with the conceptual evidence presented in the Issues Paper, including (importantly) the conclusions of Professor McKenzie and Associate Professor Partington in their advice to the AER.

Whilst we recognise that the conceptual evidence cannot, alone, determine an estimate for the return on equity, we do not agree that the advice of the two Professors supports the AER's choice of the top of the range. The advice could just as easily support a point estimate significantly below this and, quite possibly, near (or at) the bottom of the range. In this regard we note their comment that:

> *Taken together, the previous conceptual discussion clearly provides evidence to suggest that the theoretical beta of the benchmark firm is very low. While it is difficult to provide a point estimate of beta, based on these considerations, it is hard to think of an industry that is more insulated from the business cycle due to inelastic demand and a fixed component to their pricing structure. In this case, one would expect the beta to be among the lowest possible and this conclusion would apply equally irrespective as to whether the benchmark firm is a regulated energy network or a regulated gas transmission pipeline.* (Quoted on p. 17 of the Issues Paper)

To us, the use of words such as "very low" and "the lowest possible" along with the comment that the industry is one of the "more insulated" could well suggest they did not have the top of any range in mind.

We note that this 'very low risk' assessment is also broadly consistent with the additional advice provided to the AER by Frontier Economics.

For the AER to justify a point estimate at the top of the range would seem to require compelling additional supporting evidence.

2.2 Empirical Evidence

Whist we support the use of empirical information to help determine the return on equity, we have concerns about how the AER has used this information to support its choice of 0.7. We elaborate on this below:

- Henry's 2009 estimates provided to the AER would seem to support the range proposed by the AER but do not justify the selection of a point at the top of this range. Henry's estimates, together with subsequent ones by the ERA and even SFG would seem to support a point estimate well below 0.7.
- The AER expresses concerns about the use of international comparisons in helping to set the return on equity, including that these returns can reflect differences in market conditions and regulations, and that the firms used may include assets that are not regulated and/or are not energy related, but it then makes use of international comparisons as a cross check in helping to set its preferred return on equity point estimate. We agree with the need for a cautious approach to the use of international comparisons but are perplexed as to why the AER, knowing the pitfalls, has included these to justify setting the return on equity at the high point of its range, that is, 0.7. This would seem to be inconsistent and not justified.
- The use of the Black Capital Asset Pricing Model (CAPM) to justify a point estimate is also difficult to understand. In the Issues Paper and elsewhere, the AER has noted that there are "major problems deriving a reasonable empirical estimate using this model" and that "theoretical analysis does not lead to a clear indication of the magnitude of the difference between the Black CAPM and the standard CAPM". This would seem to caste significant doubt on the ability of the AER to use the Black CAPM as a justification for setting the return on equity. At the very least, the AER needs to explain more clearly to consumers why it has formed a view that the Black CAPM, despite these shortcomings these shortcomings, can be used to justify a return on equity at the top of the range.
- We note that, at the time of the 2009 WACC review, the AER adopted 0.8 as the equity beta as a "conservative approach … as a step towards moving the businesses to the range from previous decisions, which set equity betas of 0.9-1.0". If this conservative approach remains a part of the AER's thinking now in not setting the return on equity below 0.7, it would not seem to be justified. The AER has acknowledged in the Issues Paper and as part of the BRP that its ability to more precisely and confidently set a return on equity point estimate has improved because of factors such as additional and better conceptual advice, improved empirical evidence and less uncertainty associated with events such as the GFC and the 'tech bubble'.
- The use of estimates taken from the water sector to justify the AER's proposed point estimate is problematic in our view. We note that there are no listed firms with regulated water assets so it is not possible to estimate the return on equity on this basis. The AER has therefore relied on estimates taken from regulators. We suggest that the AER should have far less confidence in such estimates which do not, by definition, reflect actual market outcomes but rather estimates derived by regulators for publicly-owned entities without any ability to use actual market data. It is also conceivable that their estimates reflect circularity issues in the sense that they have utilised information taken from regulatory decisions in the energy sector or from other water regulators, who may also have themselves taken a "conservative approach". To use such estimates to justify the selection of a point estimate at the top of the range becomes even more problematic.

3 Other Comments

COSBOA also provides the following additional comments on the Issues Paper:

- We support the use of a range for the return on equity from which a point estimate will be chosen.
- We support the AER's proposed choice of a 'pure play' NSP as the comparator, noting that the inclusion of non-regulated networks and non-energy assets could be expected to bias the risk estimates upwards.
- We support the use of listed Australian entities with regulated energy networks in their asset base as an appropriate comparator. We also note the limited number of these and that they can be part of a portfolio of assets that also include non regulated networks, but expect that the available data and the way the AER intends to use it should provide a sufficiently robust ad reliable basis for setting the return on equity.
- We support the request by the AER for Professor Henry to update his 2009 empirical estimates and the AER's instructions on how he is to do this.
- We note the issues associated with the treatment of outliers and unusual market events (e.g. the GFC and 'tech bubble') and support the AER's decision to request advice on this from Professor Henry.
- We support the AER proposal to set a single return on equity for all regulated energy networks – electricity and gas, transmission and distribution. We accept the AER's conclusion that separation is not justified or necessary.

ATTACHMENT: List of COSBOA 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