

Essential Energy

5.03 Allowed rate of return

January 2023

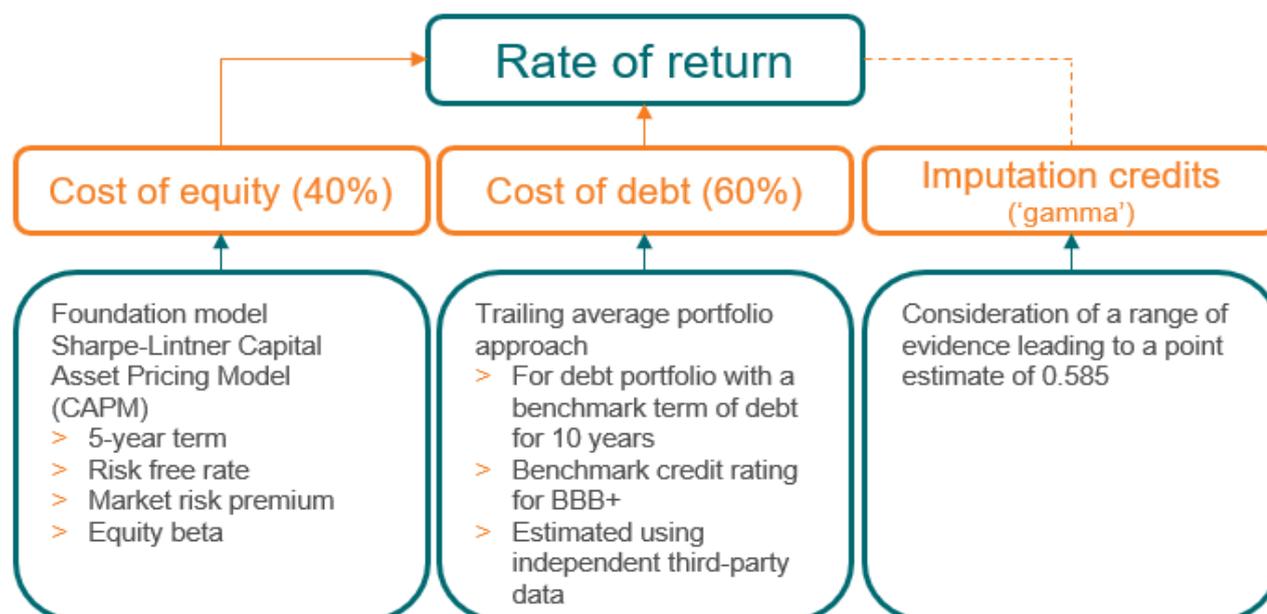


Attachment summary

- > We have used the methodology from the Australian Energy Regulator's Draft 2022 Rate of Return Instrument.
- > We are proposing a placeholder rate of return of 5.65 per cent for 2024–25.

Key components

This diagram outlines the key components of the allowed rate of return, as set out in the Australian Energy Regulator's (AER's) draft 2022 Rate of Return Instrument (RORI).



Source: Australian Energy Regulator Draft 2022 Rate of Return Instrument, Essential Energy

A new RORI is due to be finalised in February 2023 that is expected to apply to this determination. Given that Essential Energy prepared this Regulatory Proposal before then, we have used the draft 2022 RORI to develop a 'placeholder' rate of return.

We expect that the AER will substitute this with a rate of return using its finalised methodology, when making its draft and final determinations for Essential Energy. Any variance between the placeholder rates we use here and those eventually determined by the AER will flow through to customer prices for 2024–29.

Benchmark parameters

The following benchmark parameters from the draft 2022 RORI are adopted for the placeholder rate of return used in this Proposal.

Benchmark parameters	Value
Gearing	60%
Credit rating	BBB+
Debt maturity term	10 years

Our rate of return estimate is a weighted average of the cost of equity and cost of debt estimates for a benchmark-efficient firm – the weighted average cost of capital (WACC).

Cost of debt

Applying the AER's draft 2022 RORI, we propose an allowed cost of debt of **4.49 per cent** for the first year of the 2024–29 regulatory period. This has been calculated in accordance with the AER's preferred 10-year trailing average approach. It uses an averaging period of 1 March 2022 through 31 August 2022 to obtain placeholder rates for each future annual update through to the start of the 2024–29 regulatory period.

Consistent with the draft 2022 RORI, our proposed cost of debt will be subject to annual updates throughout the 2024–29 regulatory period. **Attachment 5.07 – Rate of return averaging periods (confidential)** contains our proposed nominated averaging windows for calculating the trailing average cost of debt in future years.

Cost of equity

We propose an indicative allowed return on equity of **7.38 per cent**, which has been calculated using the AER's preferred methodology and the following formula for the Sharpe-Lintner Capital Asset Pricing Model (CAPM):

$$\text{Cost of equity} = \text{Risk-free rate} + \text{Equity beta} \times \text{Market risk premium}$$

- > Risk-free rate – based on current market prices for five-year Australian Government bonds. We have used a placeholder rate of 3.30 per cent for this proposal (derived using a 60-day averaging period to 31 August 2022) that will be updated closer to the start of the 2024–29 regulatory period. **Attachment 5.07 – Rate of return averaging periods (confidential)** contains our proposed nominated averaging window for the risk-free rate.
- > Equity beta – measures the sensitivity of a business's return compared to movements in overall market returns. We have used a placeholder equity beta estimate of 0.6, consistent with the estimate adopted by the AER in the draft 2022 RORI.
- > Market risk premium (MRP) – reflects the additional return over and above the risk-free rate that would be required by an investor in a perfectly diversified portfolio of risky assets. This proposal has used a placeholder MRP estimate of 6.80 per cent, consistent with the MRP estimate adopted in the draft 2022 RORI.

The return on equity parameters used in this proposal are summarised in the table below.

Cost of equity parameters	Value
Nominal risk-free rate	3.30%
Equity beta	0.6
Market risk premium	6.80%
Cost of equity	7.38%

Value of imputation credits

Under the National Electricity Rules (NER), the allowed imputation credits (gamma) should be taken into account when determining the annual revenue requirement for a regulated business like Essential Energy. Under the Australian tax system, eligible investors can redeem imputation tax credits to reduce their personal income tax obligations to avoid being double-taxed (once through corporation tax, and again through personal income tax). The regulatory framework recognises that imputation tax credits provide an additional source of benefit to investors over and above the headline allowed rate of return. Consequently, the NER provides for the annual revenue requirement to be reduced by the expected benefit received by equity investors from imputation tax credits, such that equity investors receive just the AER's estimate of the efficient, required return on equity and no more. The higher the allowance for imputation credits in a determination, the lower the regulatory tax allowance and, therefore, the annual revenue requirement.

The draft 2022 RORI adopts a gamma estimate of **0.585**. We have adopted this as a placeholder estimate for this Proposal.

Estimate of expected inflation

In line with the AER's December 2020 final determination on its review of the treatment of inflation¹, we have adopted an estimate of expected inflation over the five-year regulatory period 2024–29.

Under the AER's new inflation methodology, the estimate of expected inflation is derived as a geometric average of the estimated inflation rate over the five-year regulatory control period.

- > The estimates of inflation for the first and second years of the regulatory control period are assumed to be the latest one-year-ahead and two-year-ahead CPI inflation forecasts published by the Reserve Bank of Australia (RBA).
- > The estimate of inflation for the fifth year of the regulatory control period is assumed to be 2.50 per cent (i.e., the midpoint of the RBA's inflation target range).
- > The estimates of inflation for the third and fourth years of the regulatory control period are derived by applying a linear glidepath between the estimates for the second and fifth years.

Using this approach, the placeholder estimate of expected inflation used in this proposal is **2.50 per cent per annum**. This estimate of expected inflation will be updated using the AER's inflation methodology closer to the start of the 2024–29 regulatory control period.

Debt raising costs

The process of raising debt finance incurs transaction costs that should be recognised in regulated revenue allowances over the 2024–29 regulatory period. To derive an estimate of efficient debt-raising costs, we have adopted the standard methodology used by the AER in recent determinations, updating the arrangement fee using Bloomberg data over the period September 2017 to August 2022.

Using this approach, Essential Energy proposes an allowance for efficient debt raising costs of **8.66 basis points per annum**, as summarised in the table below.

Cost category	1 bond	25 bonds
Arrangement fee	6.98	6.98
Bond Master Program	0.59	0.02
Legal counsel – issuer's	0.16	0.16
Credit rating – initial	0.45	0.02
Credit rating – surveillance	0.60	0.02
Registrar – up front	0.07	0.00
Registrar – annual	0.26	0.26
Agent's out of pocket	0.19	0.19
Credit rating – up front	1.00	1.00
Total (basis points p.a.)	10.30	8.66

¹ AER, *Regulatory treatment of inflation, Final position*, December 2020.

Summary

The following table summarises our placeholder estimate of the allowed rate of return for the first year of the 2024–29 regulatory control period. It is derived from the draft 2022 RORI, and will be updated using the 2022 RORI once it has been finalised.

Rate of return parameters	Value
Cost of equity (nominal post-tax)	7.38%
Cost of debt (nominal pre-tax)	4.49%
Gearing	60%
Gamma	0.585
Inflation	2.50%
Nominal vanilla WACC	5.65%