2 September 2022

Warwick Anderson
General Manager
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

By email to: RateofReturn@aer.gov.au

Dear Warwick,

Re: Submission to AER's 2022 rate of return instrument draft decision

Evoenergy welcomes the opportunity to provide a submission to the Australian Energy Regulator's (AER) 2022 review of the rate of return instrument (2022 RoRI). We acknowledge the AER's consultative approach to developing the 2022 RoRI and the range of evidence it is considering to ensure the instrument is fit for purpose.

Evoenergy owns and operates the electricity distribution network in the Australian Capital Territory (ACT) and gas distribution networks in the ACT and the Queanbeyan–Palerang Regional Council and Shoalhaven City Council local government areas of New South Wales.

The national energy market is undergoing a critical transformation that needs to be underpinned by prudent investment over the next few decades. The investment required to reduce emissions and enable greater participation in the sector will be significant. The 2022 RoRI must be robust to market conditions and encourage investment so networks like Evoenergy can continue to deliver safe, reliable and efficient services to customers now and into the future.

Our submission sets out our views on a number of matters outlined in the 2022 RoRI draft decision. Evoenergy supports the positions put forward in Energy Networks Australia's (ENA) submission.

Should you wish to further discuss matters raised in this submission, please contact Cameron Shields, Group Manager Regulatory Finance & Strategy at [redacted]

Yours sincerely

[redacted]

Peter Billing
General Manager Evoenergy

Attachment

The 2022 RoRI needs to support investment in the energy transition

Significant investment is required in the national energy market to mitigate the impact of climate change and enable greater take-up of distributed energy resources. Here in the ACT the government has announced plans to accelerate the electrification of the energy system and adoption of electric vehicles, with a target of achieving net zero greenhouse gas emissions by 2045. The ACT community expects that Evoenergy's network will keep pace with changing preferences for how energy is used, while continuing to provide a safe and reliable distribution service.

Network businesses are being asked to invest large amounts of new capital to support and enable this transition to a low carbon future. But this ambition can only be achieved by unlocking greater public and private investment over the next few decades. The RoRI plays a crucial role in enabling investment that is in the long run interest of consumers.

The AER's task of setting the RoRI now is more crucial than ever. The 2018 RoRI created abnormally low returns for network businesses due to the low interest rate environment. Evoenergy is concerned that the AER is seeking to further reduce allowed returns with the 2022 RoRI at precisely the time when greater investment is needed.

Evoenergy also notes that modelling undertaken for the Australian Energy Market Operator's (AEMO) 2022 Integrated System Plan (ISP), which outlines a 30-year roadmap of investment in the National Energy Market (NEM), suggests investment in grid enabling projects will produce net market benefits 2.2 times higher than their cost.[1]

Energy consumers are ultimately the beneficiaries of greater levels of investment. We ask the AER to consider the feedback provided by network businesses, particularly regarding the term of equity, before making its final decision.

Changing the term of equity is inconsistent with the NPV=0 principle

The key change outlined in the 2022 RoRI relative to the approach in the 2018 RoRI relates to the calculation of the term of equity. Adopting a 'term-matching' approach means the risk-free rate will reflect the yield on 5-year government bonds, instead of 10-year government bonds. This change will almost always result in a lower return on equity, and is a departure from every previous decision made by the AER on this matter.

Notwithstanding the effect of lowering the risk-free rate, the change also deviates from the conclusions reached by other regulators both in Australia and internationally on the calculation

[1] Australian Energy Market Operator (AEMO), 2022 Integrated System Plan, June 2022, p.15.

of the term of equity. The 2022 draft RoRI Explanatory Statement outlines key reasons for the change, including:

> *…We are determining a return on equity that will typically last for 5 years and then will be reset and applied to the residual value of the accumulated regulatory asset base going forward. In these circumstances, if we use anything other than the term of the regulatory period, then the zero net present value condition is not met, and investors are not correctly compensated for risk. An efficient network would not have an expectation of achieving a normal return.*[2]

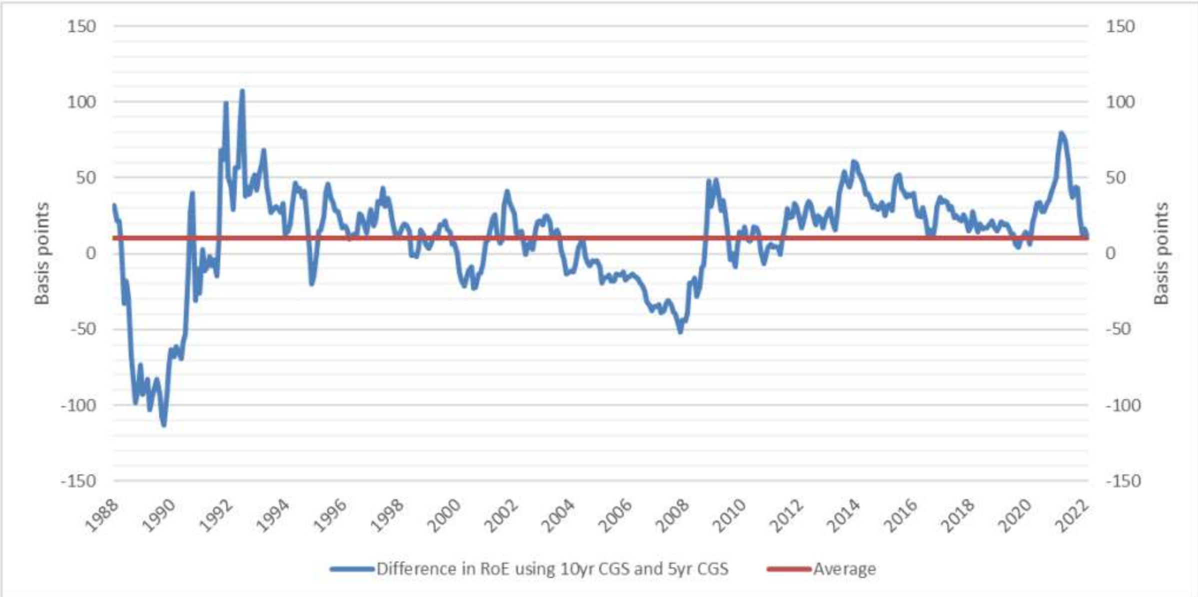
The underlying argument that term-matching is required to meet the condition that the net present value of the investment is equal to zero is not supported by market evidence or investor practice.

The goal of the AER should be to match regulatory returns to the market cost of capital, which reflects the approach that real world investors use to value long-lived assets in network businesses like Evoenergy. Efficient and prudent network businesses require a long-term rate of return that reflects the cashflows they expect to receive over the life of their assets. The term of equity should be a proxy for the life of regulated assets, which is a conclusion that is consistent with the NPV=0 principle. Using the shorter term will lead to negative NPV outcomes and violate the NPV=0 principle.

Further, we note the analysis presented by the AER comparing the allowed return on equity using 5-year and 10-year government bonds over the period 1988 to 2022 (Figure 1).

[2] AER, *draft rate of return instrument: explanatory statement*, June 2022, p 14.

Figure 1: Difference between return on equity based on 5-year and 10-year CGS yields, 1988 to 2022[3]



While the analysis shows the 5-year government bond, on average, produces a lower return on equity, it does not do so during recessions and financial crises (i.e. in 2008 and early 1990s). It is for this reason we argue that the change is not in the long run interest of consumers. Energy consumers will pay more during times of deep recession when the yield curve on government bonds inverts.

We ask the AER to reconsider its position for the term of equity based on the available evidence presented by a range of experts.

The AER should consider giving weight to the calibrated divided growth model proposed by the ENA to inform calculation of the Market Risk Premium

We note the AER's draft decision is to maintain its approach to rely on historical excess returns (HER) to calculate the market risk premium (MRP). However, the draft decision suggests that the AER is open to considering giving some weight to dividend growth models (DGM) to calculate the MRP.

Evoenergy supports the significant work done by the ENA to respond to concerns put forward by the AER in its 2018 RoRI regarding use of DGMs. We support the AER giving some material weight to an unbiased DGM approach, such as the calibrated DGM approach proposed by the ENA, that could be updated at the time of each determination.

[3] AER, *draft rate of return instrument: explanatory statement*, June 2022, p 98.

We do not support an approach to incorporate a DGM that produces an unbiased estimate, relative to the HER approach over the same time period. Incorporating or giving weight to a DGM approach will produce a better and more stable estimate of the MRP over longer time horizons.

Adopting international comparators will make the AER's method of estimating an equity beta more robust

We note the AER's approach to estimating equity beta in the draft 2022 RoRI remains unchanged from the 2018 RoRI. This is despite the set of comparator firms the AER uses to estimate equity beta now only including one actively listed firm. The set of domestic comparator firms that are actually listed on the ASX is too low, and may fall further.

The AER should consider changing its approach to include international comparators – an approach adopted by other Australian regulators – to increase the robustness of its approach to estimating equity beta. We note the advice provided by the Independent Panel:

> *Encourages the AER to consider a wide a (sic) group of proxies and alternative sources of insight.*[4]

And that the Independent Panel also noted that:

> *It is critical that the AER complete, as soon as possible, an analysis of alternative methodologies for estimating beta including, but not limited, to use of international comparators… Ideally, that work should be undertaken prior to the final determination.*[5]

Evoenergy requests the AER consider a wider range of evidence before it finalises the 2022 RoRI to ensure the final instrument includes a robust data-set to estimate equity beta.

Evoenergy supports the AER's draft decision to maintain its approach to calculating the return on debt

The draft 2022 RoRI largely maintains the AER's approach to estimating the allowed return on debt. The approach is robust, easily understood and provides regulatory certainty and stability to network businesses.

The approach is also symmetrical over market cycles and allows network businesses to plan for, and invest with confidence over long time horizons. Evoenergy suggests that there is no need to change or re-examine elements of the RoRI where there is broad support from a range of stakeholder groups. Evoenergy therefore support the AER maintaining its current simple training average approach.

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[4] AER Panel, *Independent panel report: AER draft Rate of Return Instrument*, August 2022, p 39.
[5] AER Panel, *Independent panel report: AER draft Rate of Return Instrument*, August 2022, pp 40-41.

The AER should further consider the higher risks facing investors in gas infrastructure assets within its regulatory framework

The AER's position is to maintain a single benchmark electricity and gas business for the 2022 RoRI. This position has not changed since the 2018 instrument and was investigated again as part of the 2022 RoRI process. While we agree in principle with this position at this time, Evoenergy suggests that a change may be needed in the future.

The ACT is moving faster than other jurisdictions to electrify its network and is at the forefront of the national energy transition. As jurisdictions pursue net zero emission targets and a greater focus on electrification, investors in gas infrastructure assets face a higher level of risk, compared to investors in electricity assets.

In our 2021-26 Gas Access Arrangement proposal, we successfully argued to accelerate the depreciation profile of some new gas infrastructure assets to align with government targets to phase out gas usage in the ACT by 2045. We note that the Victorian gas businesses' proposals for their upcoming access arrangements have also included accelerated depreciation profiles for both new and existing assets.

We support accelerated depreciation as one of a number of solutions to ensure efficient capital recovery, stable prices, and service quality as consumers transition away from gas usage. This approach will reduce the impact on customers over the long run. However, we acknowledge that a range of solutions are required.

A coordinated policy response is needed, with firm commitments from governments to avoid stranding assets, declining service levels and financial hardship for customers. Regulatory frameworks need to be adaptive to ensure they continue to support the National Gas Objective. Without these supports the RoRI will not be robust to the risks facing investors in gas infrastructure assets.

The AER's regulatory approach needs to be flexible to support a measured and responsible energy transition that allows gas businesses to achieve efficient cost recovery and stable price paths for customers. Ultimately it will be vulnerable customers, that cannot afford the upfront costs to transition away from gas use, that will face hardship if government and regulatory responses are not coordinated.

Evoenergy asks the AER to consider the risk facing gas networks holistically and re-consider the issue again in future RoRI decisions, as necessary, as we accelerate towards a low carbon future.

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