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4 May 2018

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

Dear Mr Anderson

Review of rate of return guideline – evidence sessions

Evoenergy welcomes the opportunity to provide a submission on the rate of return guideline evidence sessions, discussion papers and transcripts. Evoenergy has found the evidence sessions a useful process for identifying and prioritising key areas of agreement and differences between experts, and an important step in developing a guideline that is capable of acceptance by all stakeholders. This submission provides Evoenergy's high level views on key issues covered in the evidence sessions. Evoenergy supports the more detailed submission prepared by the Energy Networks Association (ENA) on the issues covered in the evidence sessions to date (being gearing, financial performance measures, risk and judgement, gamma, equity beta, the market risk premium (MRP) and the automatic application of the rate of return) and this submission should be read together with the more detailed ENA submission.

Evoenergy understands that the AER will conduct a separate consultation process in relation to the cost of debt and looks forward to providing its views in later stages of the guideline review process.

Principles for the new guideline

Evoenergy considers the rate of return guideline should be consistent with the decisions of the Australian Competition Tribunal (Tribunal) and Federal Court and is otherwise supportive of an evolutionary approach to the rate of return guideline review. There has been substantial time and effort invested in the Tribunal and Federal Courts reviews and, accordingly, any rate of return guideline should be consistent with their decisions. Where a change is considered appropriate, it should be applied symmetrically (in the same way to potential increases and decreases in parameter estimates) and consistently (if one parameter is left unchanged then other parameters, where the evidence for change is weaker, must also be left unchanged). Further, the AER should only change the value of parameters in a manner that is consistent with the direction of market evidence since the 2013 guideline. This approach will provide stability and predictability, which is important for all stakeholders.

Evoenergy believes that, if the draft Council of Australian Governments (COAG) legislation is passed and COAG's proposed consequential changes to the Rules are made[1], the efficient financing cost of the benchmark efficient entity would remain the appropriate basis for determining the rate of return. This is consistent with the incentive-based regulatory framework, the National Electricity Objective (NEO) and National Gas Objective (NGO). Evoenergy notes that during the evidence sessions, most experts agreed that the Allowed Rate of Return Objective (ARORO) is consistent with the NEO and NGO and should be maintained as the working objective of the new binding guideline[2]. Evoenergy supports this proposal.

Evoenergy agrees with the principle that all forms of risk must be accommodated somewhere within the regulatory framework[3]. Under the AER's current approach, only systematic risk is relevant to equity beta and estimation of the rate of return. However, the role of the network is changing and this change is likely to accelerate over the coming years as consumers continue to embrace new technology that must be accommodated in the distribution network. Any change in systematic risk arising from these changes will take some time to be reflected in beta estimates, so it will be important for the AER to consider these changes in determining the direction of beta estimates. Further, the AER needs to be clear about what risk it is compensating for in the rate of return so that other risks can be included in other parts of the regulatory proposal.

Evoenergy is supportive of fixing the values of relatively stable rate of return parameters including gearing, gamma and equity beta for the duration of the new guideline. However, other parameters should be set with reference to market data at the time of the determination and, accordingly, the new guideline should fix the methodology for determining the value of those parameters.

Evoenergy understands that the AER will need to apply some judgement in determining the methodology to set market parameter values. However, the judgement applied should be transparent and applied consistently. In accordance with the draft COAG legislation, the final methodology for determining parameters should be mechanistic and capable of automatic application without the exercise of any discretion by the AER[4] so that it can be replicated by stakeholders and its application at the time of the determination and the resultant market parameter value estimates, are uncontroversial. In order to establish confidence in the guideline methodology and process, particularly in the absence of Limited Merits Review, it is important that the AER's discretion is limited and, where applied, is justified on a transparent basis.

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[1] COAG 2018, Draft legislation to create a binding rate of return instrument and accompanying Bulletin dated March 2018. http://www.coagenergycouncil.gov.au/publications/national-electricity-law-and-national-gas-law-amendment-package-%E2%80%93-creating-binding-rate.

[2] CEPA 2018, Rate of return guideline review – facilitaton of concurrent expert evidence, Expert Joint Report, p.14.

[3] Ibid, p24.

[4] 4 *Statutes Amendment (National Energy Laws) (Binding Rate of Retum Instrument) Bill 2018*, Part 2, section 6, proposed new section 18J(3)(b) of the National Electricity Law.

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Priorities for the guideline review

Given the limited time for the AER to publish the draft 2018 rate of return guideline, it is Evoenergy's view that the AER should prioritise the issues to be reviewed. Specifically, Evoenergy considers that the value or methodology for determining a number of the rate of return parameters has either been settled through the appeals process or is relatively uncontroversial. In Evoenergy's view, these low priority parameters include gearing and gamma.

For the cost of equity, it is Evoenergy's view that the adoption of the foundation model for the new guideline is appropriate as the appeals process found no error with this approach and it is consistent with the evolutionary approach to the rate of return guideline review supported by the majority of stakeholders. However, within the foundation model framework, the estimation of the equity beta and the MRP remain controversial and the guideline review should prioritise these issues.

High priority issues

It is Evoenergy's view that (of the issues coverered in evidence sessions to date) the issues that should be prioritised for the guideline review are the estimation of equity beta and the MRP.

On equity beta, it is Evoenergy's view that:

- The value of equity beta could be set for the term of the guideline. The relevant evidence supports an equity beta of at least 0.7[5] and, having regard to the benefits of certainty and stability which were recognised in the relevant evidence session[6], Evoenergy supports retaining a fixed value of 0.7 for equity beta for the term of the new guideline.
- If the value of equity beta is not set for the term of the guideline, then the new guideline needs to address the lack of transparency in the AER's current approach to estimating a point estimate for equity beta. Experts in the relevant evidence session agreed that independent experts provided with an explanation of the AER's process and the same data, would be unable to replicate the conclusions of the AER[7].
- The new guideline should explicity account for low-beta bias. The evidence of low-beta bias is compelling[8] and has not changed since the AER's 2013 guideline was published. Significantly, the Tribunal's finding of no error in the AER's 2013 guideline approach to estimating the return on equity is premised on the Tribunal's acceptance of the existence of low-beta bias[9].

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[5] Evoenergy 2018, Evoenergy Regulatory Proposal 2019-24, Attachment 8: Rate of return, imputation credits and forecast inflation: 8-5 to 8-8.

[6] CEPA 2018, Rate of return guideline review – facilitaton of concurrent expert evidence, Expert Joint Report, p54-55.

[7] Ibid, p.43.

[8] See for example Frontier Economics 2017, Low-beta bias, Appendix 8.3 to Evoenergy – Regulatory proposal 2019-24.

[9] Tribunal 2016a, Application by ActewAGL Distribution [2016] ACompT 4, as explained in Tribunal 2016b, Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1 at paragraphs 731, 749-750 and 779.

On the MRP, it is Evoenergy's view that:

- The AER's current approach to setting a constant MRP of 6.5 per cent results in a return on equity that is inconsistent with market evidence[10].
- It is a priority that the new guideline sets out a transparent and replicable methodology for estimating the MRP taking into account a range of relevant evidence.
- The MRP should be estimated using both backward looking historic equity market returns (HER) and forward looking implied cost of equity using dividend growth models (DGMs). DGMs are a key part of the foundation model approach developed by the AER as part of the 2013 guideline and are critical to estimating a forward-looking MRP. Evoenergy notes that experts involved in the relevant evidence session agreed that there were three techniques that may be considered to estimate the MRP: backward looking HER, forward looking DGMs and surveys of market participants[11]. Most experts agreed that there was a role for both HER and DGMs in estimating the MRP, although there was less agreement on the role of surveys due to reliability concerns[12].
- If the new guideline does not set a value for the MRP for the term of the guideline, then the estimation methodogy specified in the new guideline should identify the weights that should be given to each source of evidence in estimating the MRP.

Low priority issues

Evoenergy considers gearing and gamma relatively low priorities for the rate of return guideline review for the following reasons:

- Gearing could be re-estimated based on updated data, however, this is unlikely to lead to any significant change to the current value[13]. In the interests of stability and predictability for consumers, businesses and investors (and consistent with the evolutionalry approach supported by stakeholders), Evoenergy supports maintaining the current gearing value of 60 per cent.
- For gamma, Evoenergy accepts that the AER's utilisation approach will be adopted in the new guideline consistent with the Federal Court decision. In Evoenergy's view, a direct estimate of gamma can be taken from Australian Tax Office (ATO) statistics. If any additional work is to be undertaken on gamma then it is Evoenergy's view that this should focus on addressing any outstanding concerns with the use of ATO data as discussed in the evidence sessions[14].

Role of profitability metrics in the guideline review

Under an incentive-based framework, Evoenergy does not consider there to be any role for ex-post profitability measures or RAB multiples in setting the rate of return. Evoenergy notes

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[10] See for example Frontier Economics 2017, The market risk premium, Appendix 8.4 Evoenergy – Regulatory proposal 2019-24.

[11] CEPA 2018, Rate of return guideline review – facilitaton of concurrent expert evidence, Expert Joint Report, p.57.

[12] Ibid, pp.58-63.

[13] See for example, AER 2018, Discussion paper – Gearing, p.5.

[14] CEPA 2018, Rate of return guideline review – facilitaton of concurrent expert evidence, Expert Joint Report, p.73-74.

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that most experts during the evidence sessions agreed that ex-post firm-specific profitability data contains no information that assists in estimating the rate of return required by the market[15]. Further, most experts agreed that RAB multiples could not be used to draw inferences about the required rate of return and there were numerous reasons why observed RAB multiples may be above one[16].

Evoenergy looks forward to further open and constructive engagement on the rate of return with the objective of establishing a predictable, transparent and evidence-based guideline that allows for the efficient financing of long-lived instrustracutre to meet the needs of electricity consumers.

If you wish to discuss any aspect of our response, please do not hesitate to contact Alexis Hardin, Manager Regulatory Finance and Strategy on 02 6248 3033 or alexis.hardin@actewagl.com.au

Yours sincerely

David Graham

Director Regulatory Affairs and Pricing

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[15] Ibid, p.35

[16] Ibid, p.35-36 and Biggar 2018, Understanding the role of RAB multiples in regulatory processes.