Rate of Return Guidelines – Issues Paper

Submission from
Jemena Limited to the
Australian Energy Regulator

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1 Executive summary

Jemena Limited (**Jemena**) welcomes the opportunity to respond to the Australian Energy Regulator's (**AER's**) issues paper on the rate of return guidelines (the **guidelines**).

All stakeholders have an interest in getting these guidelines right – and Jemena is no exception. As an owner and operator of gas and electricity networks, Jemena is well-placed to provide helpful input into the AER's consultation on the guidelines.

Jemena endorses the ENA's submission

The Energy Networks Association's (**ENA**'s) submission is well-considered, with support from experts, and helps bring together the views of gas and electricity network businesses. Although further work is needed by all stakeholders and the AER on developing the guidelines, the ENA's submission is a useful first step.

Jemena also makes a couple of key points

Specifically, Jemena considers that:

- the long-term interests of consumers are important – and these are best served by applying the new rate of return rules (the **Rules**) rather than including these interests as a separate consideration when determining the cost of capital
- gas networks are riskier than electricity networks – and, where this additional risk is found to be material and measurable, it should be considered when developing the guidelines
- the guidelines should preserve the option for networks to propose any of the three cost of debt approaches – as no one approach is 'efficient' in all circumstances
- the ENA's proposed three-step framework for estimating the cost of equity is better than the single cost of equity model approach discussed in the AER issues paper.

Jemena also responds directly to the 22 questions set out in the AER's issues paper, drawing on the ENA submission in some places.

Jemena will actively participate in the guidelines consultation process

Jemena further welcomes the opportunity to consultant with the AER through its working groups, forums and future consultation papers as it seeks to develop the guidelines.

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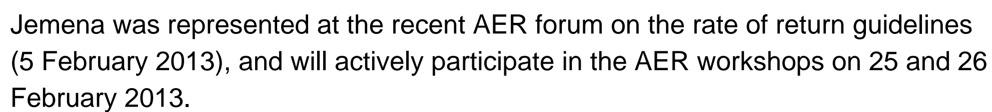

Jemena was represented at the recent AER forum on the rate of return guidelines (5 February 2013), and will actively participate in the AER workshops on 25 and 26 February 2013.

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2 Introduction

2.1 Context of the guidelines

The November 2012 Australian Energy Market Commission (**AEMC**) rule changes on network regulation[1] require that the AER establish a number of guidelines to assist investor, service provider and consumer confidence in the framework. In particular the guidelines were introduced to ensure that the regulator is transparent about its approach, and consults extensively, when determining the allowed rate of return.

The AER rate of return issues paper published in December 2012 is the first consultation in its 'Better Regulation' program. This submission is in response to that consultation.

2.2 Jemena's network businesses

Jemena owns two network businesses: Jemena Gas Networks (NSW) Limited (**JGN**) and Jemena Electricity Networks (Vic) Limited (**JEN**).

JGN is a covered pipeline service provider, within the meaning of the National Gas Rules (**NGR**), that serves 1,100,000 consumers in Sydney, Newcastle, Central Coast and Wollongong and over 20 regional centres across NSW.

JEN is an electricity distribution network service provider (**DNSP**) that serves 320,000 consumers in north western Melbourne.

Jemena also has ownership interests in the United Energy electricity distribution (**UED**) business in Victoria (34%) and the ActewAGL gas and electricity distribution partnership in the Australian Capital Territory (50%). Jemena also owns the Eastern Gas Pipeline, Queensland Gas Pipeline, VicHub pipeline and the Colongra Gas Transmission and Storage Facility.

2.3 Structure of Jemena's submission

This submission sets out Jemena's response to the issues raised by the AER.

The remainder of this submission is set out as follows:

- Section 3 explains why the consumer interest is important – and embedded in the new Rules

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[1] AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012*, 29 November 2012.[2] Section 23, National Gas (South Australia) Act 2008 (**NGL**).

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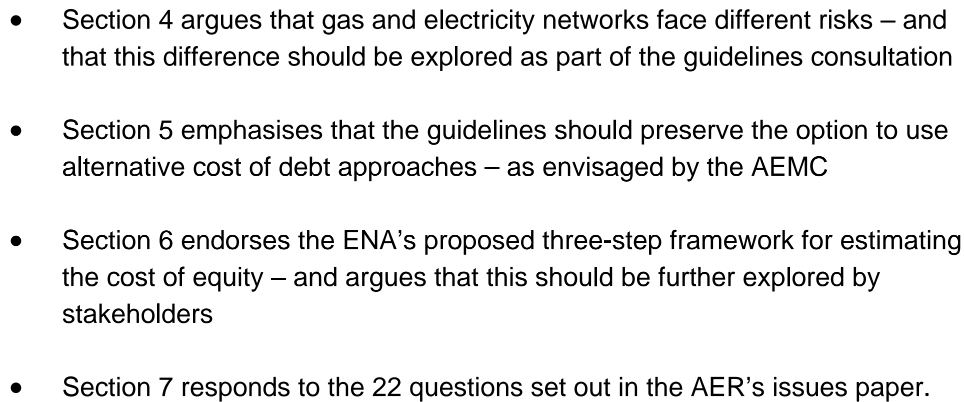

- Section 4 argues that gas and electricity networks face different risks – and that this difference should be explored as part of the guidelines consultation

- Section 5 emphasises that the guidelines should preserve the option to use alternative cost of debt approaches – as envisaged by the AEMC

- Section 6 endorses the ENA's proposed three-step framework for estimating the cost of equity – and argues that this should be further explored by stakeholders

- Section 7 responds to the 22 questions set out in the AER's issues paper.

This submission is complementary to and should be read in conjunction with that of the ENA – which Jemena endorses.

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3 Consumer interest is important

Key points:

- The long-term interests of consumers are paramount, as embodied in the national gas objective (**NGO**) and the national electricity objective (**NGO**) – but what does this mean?
- At its core, these objectives require balancing:
  - consumer desire for quality services at the lowest prices in both the short- and long- terms, with
  - efficient network investment in the long-term – by ensuring network businesses are incentivised to finance that investment and recognising the asymmetric cost from under-investment.
- The AEMC balanced these interests when setting the overall rate of return objective – which Jemena considers does a good job.
- If this balance is right, then the consumer interests are best served by ensuring that the rate of return objective is met, rather than including these interests as a separate consideration or principle when setting the cost of capital.

3.1 What are the long-term interests of consumers?

3.1.1 A balancing of short and long term interests

The long-term interest of consumers is embodied in the NGO:[2]

> *The objective of this Law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.*

And the NEO: [3]

> *The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:*
>
> > *(a) price, quality, safety, reliability and security of supply of electricity;*
> >
> > *and*

[3] Section 7, National Electricity (South Australia) Act 1996 (**NEL**).

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(b) the reliability, safety and security of the national electricity system.

But what is this 'long-term interest'?

Naturally consumers want the best quality, safe and reliable service at the lowest price in both the short- and long- terms. But there is a tension – or rather, a need to balance this want with efficient long-term investment in the networks. If prices are set too low, then this investment may not occur and the quality service may not either.

To ensure that this required investment does occur, network businesses must be financially viable over the long-term. This requires that businesses are provided with a reasonable opportunity to recover at least the efficient costs of providing the relevant services – as provided for in the revenue and pricing principles (**RPP**).[4]

This element of the RPP recognises that the social cost of allowing too little revenue to network businesses is greater than the social cost of allowing the same amount too much – an asymmetry risk, if you will.

For instance, in its 2001 review of the access arrangement regime, the Productivity Commission observed that:[5]

> *Third party access and the resulting benefits to service users are only possible over the longer term if there is continuing investment in the essential infrastructure services themselves. On the other hand, while denial or monopoly pricing of access imposes costs on the community, such behaviour cannot threaten the continued availability of the services concerned. This asymmetry in potential outcomes highlights the priority that access regulation must give to ensuring that there are appropriate incentives for efficient investment.*

More recently, when discussing the rule change request that ultimately lead to the new Rules, the AER Chairman (Andrew Reeves) recognised that:[6]

> *[T]he economic cost of under-investment in services is greater than the economic cost of a small over-investment. This asymmetry is well understood in regulatory economics and is key to the deliberations of regulators.*

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4 Section 7A of the NEL and section 24 of the NGL.

5 Productivity Commission, 2001, *Review of the National Access Regime, Report No. 17, AusInfo, Canberra*, p. xix.

6 Andrew Reeves, 23 November 2011, *Promoting efficient investment – protecting consumers from paying more than necessary, AEMC Chairman's Address, AEMC Public Forum*, p. 2.

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3.1.2 *The AEMC has a view, and embodied this into the rate of return objective*

The cost of capital is a significant and critical component of the total costs that businesses incur. If the cost of capital allowance is inadequate, then network businesses may fail or curtail investment, or both. Neither of these outcomes is in the long-term interests of consumers.

Put another way, the long-term interests of consumers are best served by ensuring that network businesses' allowed revenues cover their efficient costs of capital.

The AEMC expressly considered this when drafting the new Rules:[7]

> *Efficient investment requires that the costs gas service providers incur in providing services to their customers should reflect efficient financing costs. This is to allow gas service providers to attract sufficient funds for investment while minimising the resultant costs that are borne by consumers.*

And: [8]

> *[T]he rate of return [should reflect] efficient financing costs necessary to attract sufficient investment capital to maintain a reliable electricity supply while minimising the cost to consumers.*

On the basis of these and other considerations,[9] the AEMC went on to add the rate of return objective into the NGR and the NER.[10] According to the legislative structure and rule-making process,[11] if this objective is met (and the Rules applied correctly), then the long-term interests of consumers are served.

In other words, if the new Rules are applied correctly – and the rate of return objective met – then network businesses should have the opportunity to earn enough revenues to attract efficient investment.

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7 AEMC, 29 November 2012, E*conomic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services*, *Final Position Paper*, p.17.

8 *Ibid*, p.12.

9 See AEMC, 29 November 2012, E*conomic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services*, *Final Position Paper*, pp. 7–15 and 17–21.

10 Rule 87(3), *National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012 No. 3*, and

Clause 6.5.2(c),*National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 No.9*.

11 For instance, section 72 of the NGL and section 32 of the NEL require that, in performing or exercising any function or power under this Law, the Regulations or the Rules, the AEMC must have regard to the national electricity objective.

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3.2 How should the guidelines serve the long-term interests of consumers?

3.2.1 Focus on meeting the rate of return objective

The guidelines need not and should not give specific consideration to the long-term interest of consumers – whether as a principle or some other consideration. Rather, the guidelines should focus on meeting the rate of return objective. Doing otherwise is unnecessary and may create uncertainty in the application of the Rules and guidelines.

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4 Risk profiles may differ between electricity and gas networks

Key points:

- Gas and electricity networks face different risks, the question is are these differences material and measurable – and to answer this requires further consideration by the AER and other stakeholders.
- An initial review suggests that these differences may be material and measurable, but this should be further explored by comparing:
  - the volatility of annual revenues, and
  - credit ratings (and so debt financing costs)

  of networks.
- If confirmed, then the guidelines should recognise these differences when setting the costs of capital for gas and electricity networks separately.

4.1 Do gas and electricity networks face different risks?

4.1.1 Maybe, gas networks appear riskier than electricity businesses

Gas networks appear inherently riskier than electricity networks – at least to Jemena. Conceptually, this may hold because gas networks face:

- greater market or volume risk – gas demand usually has less market saturation and higher sensitivity to winter weather with less predictability than electricity demand, and
- greater competition – gas, as an energy source, competes with electricity for all household appliances, but the reverse is not true.

The AER previously noted that gas networks may be riskier in the 2009 WACC review:[12]

> *[G]as businesses may have a higher business risk than electricity businesses due [to] greater volatility in cash-flows from relatively higher volume risk compared to electricity network businesses.*

[12] AER, *Electricity Transmission and Distribution Network Service Providers Review of the Weighted Average Cost of Capital (WACC) Parameters, Explanatory Statement*, 1 May 2009, p. 108.

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And:[13]

> *The AER acknowledges that gas network businesses with similar financial credit metrics to electricity network businesses may have lower credit ratings.*

In its 2010 initial response to the AER's draft decision, JGN pulled these observations together by submitting (to the AER) that gas networks are materially riskier than electricity networks in Australia because they tend to have:[14]

- more volatile annual revenues, and
- lower credit ratings.

Although the AER was not convinced at that time, the question of whether any differences in risk are material remains open.

4.1.2 Further review is needed

If anything, these observations suggest that further review is needed by the AER and other stakeholders as part of the guidelines consultation. This review would need to confirm whether gas and electricity networks in Australia face different risks that are both material and measurable.

One approach to measuring differences may involve comparing the risk metrics (including credit ratings and equity beta estimates) of a large sample of gas and electricity networks. At present, there are relatively few such networks in Australia. So this comparison may need to look at foreign markets such as the US or the UK.

Other approaches may involve comparing revenues from a similar sample of networks or looking at approaches used by other regulators.

4.2 How should the guidelines reflect any differences?

4.2.1 If material, then the guidelines should ensure that the cost of capital differs between gas and electricity networks

Further analysis may confirm that gas networks are riskier and therefore attract higher costs of debt or equity than electricity networks, or both – which could be reflected in lower credit ratings or higher equity betas.

If confirmed, then the guidelines should consider these differences when practically implementing the definition of the benchmark efficient entity. This may also require that different definitions of this entity are used for gas and electricity networks.

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[13] AER, *Electricity Transmission and Distribution Network Service Providers Review of the Weighted Average Cost of Capital (WACC) Parameters, Final Decision*, May 2009, p. 371.

[14] JGN, *Initial response to draft decision*, 19 March 2010, p. 116.

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5 Guidelines should preserve alternative cost of debt approaches

Key points:

- The NGR and NER expressly allow for the use of alternative approaches when estimating the cost of debt.
- The guidelines should recognise this by preserving the option for networks to propose a given approach at each reset and the AER to consider it.
- Jemena considers that the hybrid approach (i.e. a long-term average debt risk premium and a short term average risk free rate) is the most efficient approach for a benchmark efficient entity facing the same circumstances as either JGN or JEN.

5.1 Should the guidelines set only one alternative?

5.1.1 No, the NGR and NER expressly allow three alternatives

Specifically, the three approaches are:[15]

– the prevailing cost of funds approach

– an historical trailing average approach

– some combination of these two approaches – the hybrid approach.

In drafting the new Rules, the AEMC recognised that there are a number of efficient debt management strategies or practices – and that it was not possible to set one approach that would be efficient in all circumstances: [16]

> *The best methodology for estimating return on debt may not be the same for benchmark efficient service providers with different characteristics. Therefore, the rules should not prescribe a particular methodology for estimating the return on debt component.*

[15] AEMC, 29 November 2012, E*conomic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services*, *Rule Determination*, p. 90.

See also: Rule 87(10), *National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012 No. 3*, and

Clause 6.5.2(j),*National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 No.9*.

[16] AEMC, 29 November 2012, E*conomic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services*, *Rule Determination*, p. 72.

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Summarising its position in the draft rule determination, the AEMC:[17]

> *[C]onsidered that the long-term interests of consumers would be best served by ensuring that the methodology used to estimate the return on debt reflects, to the extent possible, the efficient financing and risk management practices that might be expected in the absence of regulation. In its draft rule, the Commission therefore proposed to make it unambiguous that the regulator can consider a range of approaches to estimating the return on debt to meet the overall rate of return objective. This would include a range of different approaches that involved using a "spot rate" methodology that used market data to reflect prevailing conditions in the market for funds or averaging estimates of the return on debt over historical periods, or some combination thereof.*

This position was not challenged in the final rule determination. The AEMC went on to say that:[18]

> *It should remain open to the regulator and service providers to consider that different sectors and different kinds of service providers have different risk characteristics that lead to different characteristics for efficient debt financing. The Commission therefore agrees that a one-size-fits-all approach to setting a benchmark should not be considered a default position.*

And finally, in relation to the guidelines, that:[19]

> *The Commission intends that the regulator could adopt more than one approach to estimating the return on debt having regard to different risk characteristics of benchmark efficient service providers.*

The AER should recognise the AEMC's consideration and guidance on the Rules when developing the guidelines.

5.1.2 The guidelines should reflect this by preserving the option to propose any one of the alternatives

Specifically, the guidelines should set out how each of the three approaches would apply at a given determination, with enough detail so that stakeholders can estimate the return on debt using any approach. This detail will help stakeholders predict cost of capital outcomes.

But the guidelines should leave open the question of which approach applies at that determination, until that determination. Instead, network businesses (and

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[17] *Ibid*, p. 76.

[18] *Ibid*, p. 86.

[19] *Ibid*, p. 90.

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other stakeholders) should propose the debt management strategy that an efficient benchmark entity would adopt in the circumstances and the approach that best matches that strategy.

The AER's task is then to determine:

- whether the proposed strategy, or some other strategy, is the most efficient in the circumstances, and
- what approach best matches that strategy, using that approach to set the allowed return on debt.

In doing so, the AER should consider the AEMC's guidance, the Rules themselves, and the body of evidence developed as part of the guidelines consultation and the stakeholder proposals.

5.2 If only one alternative is allowed, what would Jemena prefer?

5.2.1 The hybrid approach, as this is the most efficient for JGN and JEN

This approach best matches Jemena's current debt management strategy for JGN and JEN, which involves both:

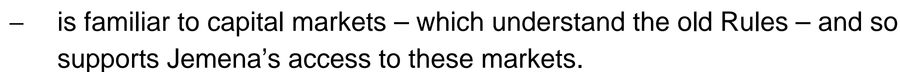
- issuing debt periodically over time to fund investment in these networks and refinancing existing debt facilities, and
- entering swap and other derivative transactions during the JGN and JEN averaging periods to hedge the risk free rate component on this debt.

This strategy is efficient because it:

- minimises Jemena's transaction costs (such as execution and portfolio management costs) when issuing this debt due to the relatively small size of the JGN and JEN regulated asset bases
- lets Jemena effectively hedge a large per cent of its interest rate risk on this debt – to the satisfaction of Jemena's debt and equity holders (and the ratings agencies),[20] and

[20] For instance, as at 31 March 2012, SPI (Australia Assets) Pty Ltd (**SPIAA**) – Jemena's parent company – had 95.20% of its variable interest rate debts hedged. This per cent is not fixed, and changes over time as market conditions and Jemena's debt management practices change.

See SPIAA, June 2012, *Financial report for the year ended 31 March 2012*, p. 57.



– is familiar to capital markets – which understand the old Rules – and so supports Jemena's access to these markets.

A relevant concern is the impact that any change in debt management strategies – and the cost of debt approach more generally – will have on the capital markets. Debt markets are already wary of changes to the regulatory regime and are still digesting the impact of the AEMC's recent rule changes.[21] For instance, in its recent credit opinion on SPIAA – Jemena's parent company – Moody's Investor Service noted that:[22]

> *Moody's expects the new rules released by the AEMC to have a negative credit effect on the Australian regulated utilities.*

The AER should, therefore, be cautious before prescribing any changes to the current approach.

[21] Financial Investors Group, 11 February 2013, *Submission on Merits Review of Decision-Making in the Electricity and Gas Regulatory Frameworks*, p. 18.

[22] Moody's Investor Service, 27 November 2012, *Credit Opinion: SPI (Australia) Assets Pty Ltd, Global Credit Research*, p. 3.

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6 ENA proposes a useful three-step framework for estimating the cost of equity

Key points:

- A framework for assessing and combining evidence to estimate the cost of equity should:
  - consider all relevant evidence, not just one model
  - ensure consistent and predictable assessment of this evidence
  - meet the rate of return objective and the Rules more broadly
  - recognise that there are a range of relevant considerations, but that the role these play in the assessment may vary from decision to decision.
- The ENA's proposed three-step framework is one that may meet these objectives.
- The AER and other stakeholders need to work together to come up with a framework that best meets the new Rules.

6.1 What is the ENA's three-step framework?

6.1.1 One that looks at all evidence before arriving at a single cost of equity estimate

Specifically, the ENA proposes applying three steps to estimate the cost of equity:

- **Step 1**: Identify the relevant methods, models, data and evidence.
- **Step 2**: Compute the best estimate of the required return on equity for the average firm using each approach/piece of evidence, and distil from that an estimate of the required return on equity for the average firm.[23]
- **Step 3**: Compute the best estimate of the required return on equity for the benchmark firm using each approach/piece of evidence, and distil from that an estimate of the required return on equity for the benchmark firm. This step is incremental to step 2 above.

[23] Here, the 'average firm' is a firm of average risk (whatever definition of risk is relevant under a particular model) or the market as a whole. For example, in the Sharpe-Lintner CAPM, the average firm, and the market portfolio, have a neutral equity beta of 1.0.

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These steps are further detailed in the ENA's submission.

Clearly, this framework leaves open the question of how to distil all relevant evidence into a single cost of equity. Ultimately, this will involve the use of the cost of capital considerations (or principles) and the transparent application of regulatory discretion.

6.1.2 A framework that meets the new Rules

The ENA framework meets the new Rules because it:

- considers all relevant estimation methods, financial models, market data and other evidence
- supports the rate of return objective and the Rules more broadly – by considering the prevailing conditions in the market for equity funds and any interrelationships between financial parameters.

The ENA framework also:

- ensures consistent and predictable assessment of relevant evidence
- recognises that there are a range of relevant considerations, but that the role these play in the assessment may vary from decision to decision.

By meeting these objectives, Jemena considers that the ENA's proposed framework better meets the new Rules than other options such as the single preferred model approach (with or without cross checks) outlined in the AER issues paper, which may not consider all relevant evidence.

6.1.3 Further review is needed

The AER and other stakeholders will need to work together to develop a framework that best meets the new Rules. This may reflect the ENA's proposed framework, or it may not.

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7 Responses to AER questions

In its issues paper, the AER seeks stakeholder views in response to a number of questions. Jemena has provided its responses in Table 7–1.

Table 7–1. Jemena response to AER questions.

AER question	Jemena response
Principle based approach	
1. Do stakeholders consider that following these principles would promote the allowed rate of return objective? Should any of the principles be considered as more prominent than others?	• A principles-based approach is consistent with rate of return objective. If only for the sake of clarity, the term 'considerations' should be used instead of 'principles'. This will help emphasise that the principles are **not** exhaustive or determinative when considering alternative evidence. Some considerations may dominate others in some cases, but not in others. New considerations may become relevant over time. • The AER's principles are a good start – but further design and modification is needed. Jemena endorses the ENA's proposed modifications to the principles included in the AER issues paper. • Empirical validity is an important consideration when selecting between evidence – which, for instance, may favour models with strong empirical evidence over those that don't, even if the latter have solid theoretical foundations. • Finally, how the considerations (or principles) are used is important – but is currently unclear. Before the AER finalises its set of considerations, stakeholders need to identify how these are going to be used when determining the cost of capital.
2. Are there other principles or criteria which should be considered?	• Yes. The ENA proposes some additional considerations and modification or deletion of others, which Jemena supports. • It is difficult to propose a complete set of considerations at this stage in the consultation. This set will change over time and will depend on how they are applied to determine the rate of return.

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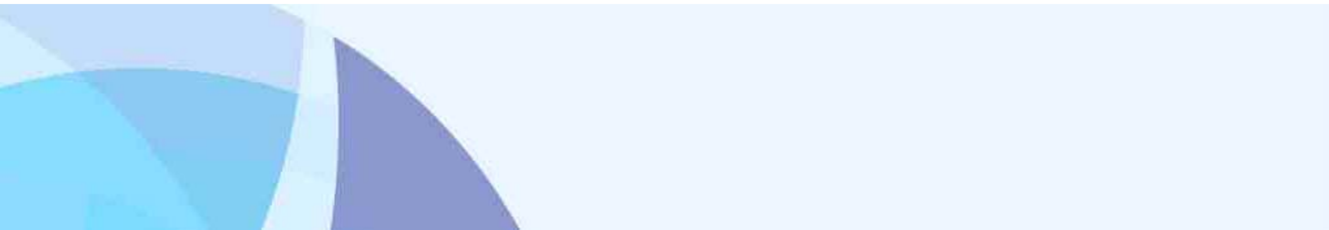

AER question	Jemena response
3. Do stakeholders have a broad preference for predictability or flexibility, and do these preferences differ at each level (the overall rate of return, the return on equity and debt, and at the parameter level) of the rate of return?	• The question is a little unclear – and needs further consideration. • Jemena prefers predictable or stable cost of capital and cost of equity *outcomes* over time, but recognises that flexibility is needed when estimating the cost of debt due to differences in efficient debt management practices between networks facing different circumstances. • Predictable outcomes align with the long-term nature of network assets and may better meet the rate of return objective (and better serve the long-term interests of consumers). Moreover, predictable outcomes may better help network businesses, such as Jemena, raise debt and equity financing for efficient long-term investment.
4. To what extent should the guideline set out a pre–determined approach that can then be applied at each determination?	• The guidelines should be clear and set out the overall methodology for setting the cost of capital. Stakeholders should be able to apply the guidelines at a given time to predicate the cost of capital that the AER would determine in the circumstance with reasonable accuracy. This means that the guidelines should be detailed. • This does not mean that the guidelines should fix all cost of capital parameters. It should, however, clearly explain the process for determining those parameters that are not fixed. • Networks should have the option to accept the guidelines in part or in full. This may mean accepting some parameters or approaches, while challenging others – provided clear justification is made, consistent with the NGR or NER.

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AER question	Jemena response
Key concepts and terms	
5. Aside from a balance between debt and equity financing, are there other characteristics of the way in which an efficiently financed entity would approach its financing task that should be considered in estimating the allowed rate of return?	• The answer to this question depends upon the definition of the benchmark efficient entity, which can only happen once the relevant risks have been identified. Relevant characteristics may include (among others): – non-diversifiable risk – company size – book to market value of equity – type of regulation. • Once the benchmark efficient entity is defined, then the efficient financing practices – target credit rating, gearing, type and tenor of debt, dividend reinvestment, capital raising, hedging – and resulting efficient financing costs – return on equity, return on debt, debt and equity raising costs, refinancing costs – can be determined.
6. Is it still appropriate to separate a conceptual benchmark from its practical implementation?	• Yes. Given Australia's limited pool of gas and electricity networks and the differences between them, it would be difficult to identify one or more networks that can truly be considered "the" benchmark efficient entity. • Hence, the guidelines should separate the definition from its implementation.
7. Does the current definition reflect an appropriate level of detail for the conceptual definition? Are there other factors which should be considered?	• No. As the ENA proposes, a better definition is: A 'pure-play' regulated electricity or gas network business operating within Australia without parental ownership providing the same scale and scope of services to the same customer base in the same regulatory period.
8. In relation to the current definition of the conceptual benchmark, is more or less detail preferable?	• More detail, as noted in response to question 7. The ENA's proposed definition rightly points out that the conceptual benchmark entity should be subject to the same external circumstances that are beyond the control of the relevant network.

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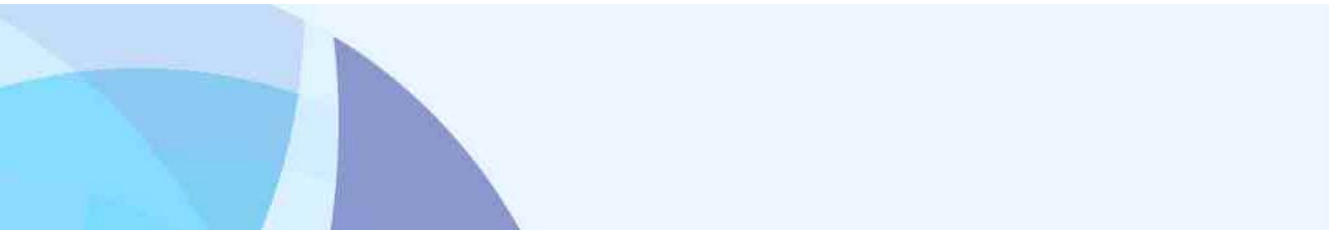

AER question	Jemena response
9. Are the proposed factors reasonable?	• Some are, but not all. The key is to ensure they are interpreted fairly. For instance, – large samples should provide more robust, more precise, and more stable estimates – but any sample, whether small or large, should be representative with limited or no bias – market practice could include both the practice of regulated network businesses and other market participants – practices in other comparable industries or those identified by practitioners may provide useful observations • Stakeholders need to further consider what factors are reasonable.
10. Are there other factors which should be considered?	• Yes. Other factors include whether: – market data, empirical evidence and observed market practice should trump theoretical assumptions – published or peer reviewed studies should trump those that are not – contemporaneous evidence should trump that which is not. • Another factor is how to address uncertain estimates, or those with high estimation error.
11. Are there characteristics that differentiate the level of risk in the gas and electricity sectors, or between distribution and transmission networks?	• Yes. Gas businesses are inherently riskier than electricity businesses. • Stakeholders need to further consider whether that difference in risk is both material and measurable.

AER question	Jemena response
12. Are there other characteristics that should be taken into account when assessing the level of risk?	• Unsure. Again, this is a question that the AER and other stakeholders need to consider further. • Other relevant characteristics may include: – level of unsystematic risk – type of regulation – geographical location – asset replacement life cycle – regulatory or sovereign risk from jurisdictional governments – consumer demographics and demand profiles, both current and future.
13. To the extent that different risk levels exist, can these differences be estimated in a manner consistent with the regulatory principles outlined in section 2?	• Unsure. Stakeholders need to further consider how to identify and measure these risks.
Overall rate of return	
14. To date our practice has been to estimate the allowed rate of return based on the standard WACC formula. Should we continue with this, or if not, what alternative approaches should be explored?	• Yes. The standard WACC formula – a weighted average of the costs of debt and equity, with an assumed gearing ratio (e.g. 60 %) – is still fit for purpose. But the debt and equity components that make this up, as well as the gearing ratio, need further consideration. • Some relevant evidence could be used to assess the cost of capital in aggregate, but this will need further consideration by stakeholders.

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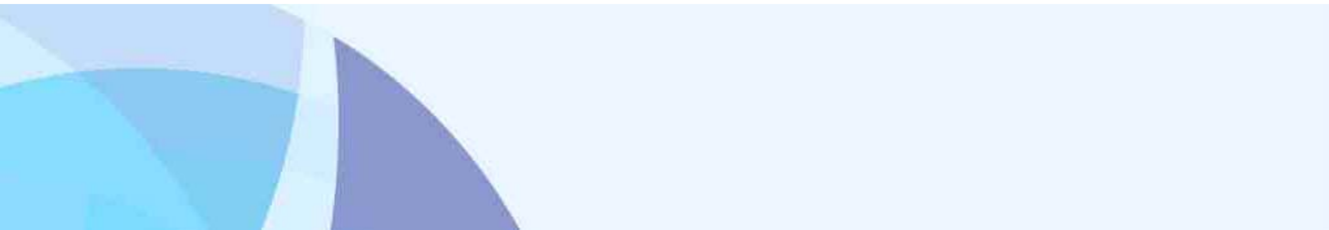

AER question	Jemena response
15. How can overall rate of return considerations be used under the new rule framework? This may include consideration of the relevance of the methodologies identified above (or others not yet identified), and how such information could be used.	• As the ENA notes, the considerations should apply at the overall decision making level rather than to individual methodologies in isolation, without being exclusive and determinative.
Return on equity	
16. Are the assessment criteria presented in section 3.1 an appropriate basis for evaluating the cost of equity methodology in order to meet the allowed rate of return objective?	• Developing a set of principles or 'considerations' to evaluate the cost of equity methodology is a necessary task. However, the particular assessment criteria presented in section 3.1 should be developed further with all stakeholders through the AER's rate of return working group. • Jemena supports the list of 'considerations' proposed by the ENA.
17. What overall cost of equity methodology best meets the allowed rate of return objective?	• An approach that draws on all relevant estimation methods, financial models, market data and other estimates to arrive at a balanced estimate of the cost of equity. • One such methodology is the ENA's three-step framework – which Jemena endorses. • This framework is simple and still needs further development – but is a useful start. For instance, the framework still needs to explain how to distil all relevant evidence into a single cost of equity point estimate. • This development should occur through further consultation between the AER and other stakeholders.

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AER question	Jemena response
18. What individual cost of equity model best meets the allowed rate of return objective?	• No one cost of equity model best meets the allowed rate of return objective. Rather, to meet this objective, the AER must consider all relevant evidence when estimating the cost of capital. • There are a range of cost of equity models – each with strengths and weaknesses. Some models may perform better at some times, but not at others. The guidelines should reflect this.
19. What other evidence (estimation methods, financial models, market data and other estimates) is relevant to the determination of the cost of equity?	• As a starting point, the AER should consider the Black CAPM, the Fama-French three factor model, the dividend growth model, and independent expert reports. • Other evidence may also be relevant – and Jemena is committed to working with the AER and other stakeholders to identify and assess this evidence.
Return on debt	
20. What are the advantages and disadvantages of portfolio approaches compared with the current "on the day" approach to the return on debt?	• Portfolio approaches may promote efficient debt management practices in some cases but not in others, as may the "on the day" approach. • The key to remember is that the NGR and NER support all three cost of debt approaches – and so should the guidelines. • The ENA submission provides a useful response to this question.
21. How do these approaches align with the principles of an efficient financing benchmark, as set out in section 4.2?	• Unsure. The AER and other stakeholders will need to further explore this question as part of the guidelines consultation.

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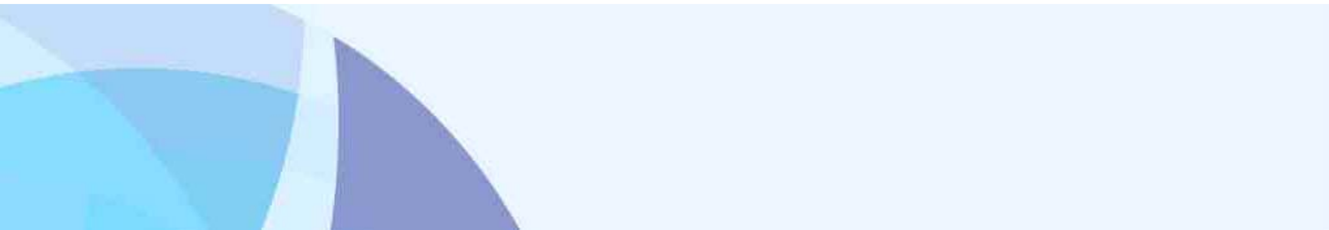

AER question	Jemena response
22. What are the characteristics of efficient and prudent financing practices that should be taken into account under a benchmark framework?	• Relevant characteristics include how an entity: – manages refinancing, interest rate, and, for international debt portfolios, exchange rate risks – minimises overall financing costs, for instance by adopting optimal bond issue sizes, coupon rates, durations and transactions costs – raises sufficient (and timely) capital to fund new investments – transitions between practices in response to changes in market conditions and the regulatory regime. • Parental ownership – whether government or private – is not a relevant characteristic.

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Glossary

AER	Australian Energy Regulator
DNSP	distribution network service provider
ENA	Energy Networks Association
JEN	Jemena Electricity Networks (Vic) Ltd
JGN	Jemena Gas Networks (NSW) Ltd
NEL	National Electricity Law
NEO	National Electricity Objective
NER	National Electricity Rules
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
RPP	revenue and pricing principles
SPIAA	SPI (Australia) Assets Pty Ltd
WACC	weighted average cost of capital

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