28 October 2013

Mr. Andrew Reeves
Chairman
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Mr. Reeves,

NSW DNSPs submission on equity beta issues paper

The NSW DNSPs welcome the opportunity to comment on the AER's equity beta issues paper. We are concerned by the AER's move to adopt an equity beta of 0.7 and consider that the available evidence supports the use of an equity beta between 0.8 and 1.0 when applying the Capital Asset Pricing Model (CAPM) to estimate a benchmark cost of equity for regulated energy network businesses in Australia.

We note that significant analysis has been undertaken by the Energy Networks Association (ENA) on the best estimate of equity beta using foreign comparators, information derived from empirical estimates of the cost of equity for Australian firms using the Black CAPM framework, the dividend growth model and the Fama-French 3 factor model. As a member of the ENA, we support the ENA's submission on the equity beta issues paper.

Under the AER's proposed foundation model approach, the equity beta is a key input to the allowed cost of equity. We do not consider that we have had reasonable or sufficient time to consider and fully respond to the equity beta issues paper. Furthermore, the late publication of the equity beta issues paper (leaving only 2 weeks for consultation) combined with the AER's proposed transitional arrangements for the cost of debt and the continued use of a short-term averaging period to estimate the risk free rate makes the range of possible allowed rate of return outcomes very wide. This has made it difficult for us to forecast the likely rate of return to apply for the 2014-15 transitional year and for the full 2014-15 to 2018-19 regulatory control period.

As we noted in our submission on the draft rate of return guideline, the cost of equity estimated based on historical data for the expected return on the market (i.e. the market risk premium), a 10 year average of the yields on 10 year government bonds and an equity beta estimate of 0.8-1.0 (based on the best available information) provides a reasonable and stable approach to estimating the regulated return on equity for energy network businesses. This approach should be combined with a full consideration of the range of available evidence on the cost of equity using relevant financial models and other evidence.

Our suggested approach to estimating the cost of equity within the CAPM is consistent with the trailing average approach used to set the cost of debt under the rate of return guidelines. The combination of our suggested approach to the cost of equity and the trailing average approach to setting the cost of debt would provide a rate of return commensurate with the efficient financing costs of a benchmark efficient entity as referred to in the allowed rate of return objective.[1] This approach would also provide relatively stable rate of return outcomes compared to the approach of applying transitional arrangements to the cost of debt and a short term averaging period to estimate the risk free rate only. We encourage the AER to consider this approach in developing its final rate of return guideline.

If you would like to discuss this matter further, please contact Mr Mike Martinson, Group Manager Network Regulation at Networks NSW on (02) 9249-3120 or via email at michael.martinson@endeavourenergy.com.au.

Yours sincerely

Vince Graham
Chief Executive Officer
Ausgrid, Endeavour Energy and Essential Energy

[1] NER, cl. 6.5.2(c).