Office of the CEO

7 October 2020

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General Manager, Networks Finance and Reporting
Australian Energy Regulator
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Dear [redacted]

Submission on AER Draft working paper: Rate of return CAPM and alternative return on equity models

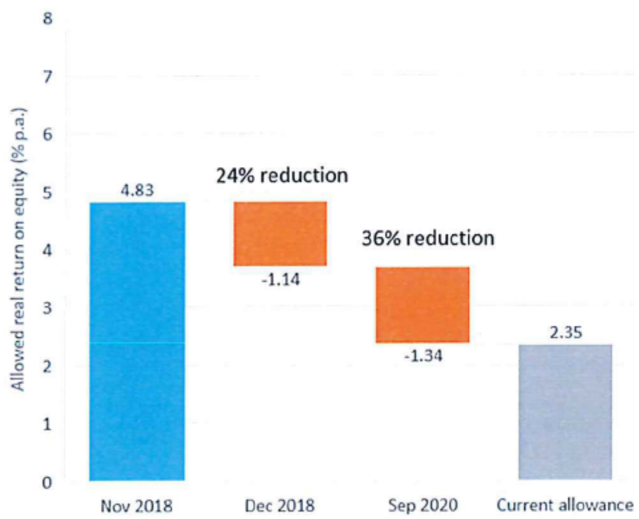
SA Power Networks welcomes the opportunity to provide a submission to the AER on its Draft Rate of return working paper: *CAPM and alternative return on equity models*. We strongly endorse the AER's approach of early engagement in relation to the 2022 Rate of Return Instrument (RoRI). This process provides an opportunity for thorough stakeholder engagement and proper analysis of approaches and evidence.

SA Power Networks has contributed to, and fully endorses, the ENA submission into this process. This submission summarises the context of the 2022 RoRI from SA Power Networks' perspective and highlights what we think are some of the key features of the 2022 Instrument.

The context of the 2022 RoRI for SA Power Networks

The ENA submission highlights that the reduction in the allowed return on equity that was implemented by the 2018 RoRI has been compounded by subsequent falls in government bond yields.

The real return on equity allowance was reduced by 24% in December 2018 and has fallen by a further 36% since.



The allowed real return on equity of 2.35%, set in our determination earlier this year, is the lowest ever allowed by any regulator of Australian networks. And, for the reasons set out in our submission to the AER's inflation review, it is highly unlikely that our equity investors will receive even that level of return.

The Brattle report commissioned by the AER indicates that the closest allowance by any other comparable regulator is 73% higher.

In addition, on a benchmark basis, SA Power Networks has been allowed Net Profit After Tax of negative $150m over the current regulatory period.

We note that the current regulatory allowances have only been in effect for our business since July this year and will flow through our accounts and investment decision making over coming years.

SA Power Networks will work hard to deliver the best possible service to consumers that such allowances permit.

The 2022 RoRI must be robust to a range of financial market conditions

SA Power Networks considers it to be very important that the 2022 RoRI is robust to potential changes in financial market conditions during its term. It must be capable of producing appropriate estimates of the efficient cost of capital in every determination that is made during its term.

The ENA submission notes that the development of a binding instrument is a much more complex task than a standard regulatory determination. It is not a point-in-time determination, but a framework for ensuring that future point-in-time determinations properly reflect the efficient cost of capital and provide incentive for efficient investment when they are made. Thus, the RoRI must be robust to changes in market conditions in a way that is not required of a standard regulatory determination. It is not enough for the RoRI to promote the National Electricity Objective and National Gas Objective at the time it is made; it must be capable of doing so throughout its term even as financial market conditions and circumstances change.

The focus of the 2018 RoRI was on whether it reflected efficient financing costs at the time it was made. We consider that it has not been robust to the extraordinary changes in market conditions that have since occurred.

We consider it important that the AER consider how the 2022 RoRI would perform under a range of market conditions that might plausibly occur during the term of that instrument.

There should be a focus on the returns required by real-world investors

The ENA submission explains the transition that is currently occurring in Australia's energy sector and identifies some of the major network investment that will be required over the coming decade. That investment will have to be provided by real-world investors. Consequently, the Capital Asset Pricing Model (CAPM) should be used as a tool for estimating the return that is required by real-world investors. Esoteric arguments about how theoretical investors might behave under a certain set of assumptions has little relevance to the "efficient market cost of capital".

Regard should be given to all relevant data and evidence

When estimating the required return on equity, the 2018 RoRI adopted the approach of estimating each parameter using a small, preferred subset of the relevant evidence. Based on its review of other regulatory approaches, and on its own expertise, Brattle has recommended that the AER should consider a broader range of relevant evidence, particularly more forward-looking evidence. We strongly endorse that recommendation.

There is an important role for cross checks and financeability tests

We endorse the ENA's submission that the next stage of engagement for the 2022 RoRI should include a process in relation to cross checks, including financeability tests.

The role of cross checks is to provide information about whether a particular allowed return on equity properly reflects the market cost of equity in the financial market conditions at the time. Thus, cross checks have an important role to play in assessing the robustness of a particular approach to setting the allowed return on equity. Specifically, cross checks would be applied when testing the allowed return on equity produced in each of a range of future scenarios.

The evidence must be assessed in a balanced way, having regard to the relevant context

To build stakeholder confidence in the process, it is important that evidence is assessed in a balanced way, having regard to the relevant context. For example, evidence would be subject to very careful scrutiny by the AER if it has a material effect on the AER's allowed return on equity, if it is inconsistent with the preponderance of existing evidence, or if it differs from the approach applied in practice.

We endorse the ENA submission that it is important that stakeholders do not:

- raise some potential estimation issues relating to one model or approach and use that as the basis for disregarding entirely all evidence that is contributed by that model or approach;
- raise some potential estimation issues relating to one model or approach, while ignoring a larger set of estimation issues relating to another (favoured) model or approach;
- raise some potential estimation issues without testing whether those potential issues do in fact arise in the relevant data; or
- raise some potential estimation issues without considering how those issues might be addressed or corrected.

Due consideration should be given to the recommendations from the AER's consultants

We urge the AER to carefully consider the recommendations from the consultants that it has commissioned in recent months.

In particular, Brattle have made a series of recommendations based on their analysis of the practice of other regulators and on their own expertise. We note Brattle's finding that the current allowed return on equity (in both nominal and real terms) under the 2018 RoRI is lower than that allowed by any comparable regulator. We endorse Brattle's recommendations that the AER should:

- have regard to a wider range of relevant evidence when estimating CAPM parameters;
- have regard to forward-looking estimates, particularly in relation to the market risk premium;
- have regard to international comparators when estimating beta, given the paucity of domestic evidence in relation to that parameter; and
- avoid approaches whereby some components of the allowed return on equity are fixed in accordance with market conditions at one point in time, and others are subsequently updated to reflect market conditions at a different point in time.

We also note that Sapere has identified that a regulatory allowance that forces benchmark networks into a loss-making position (as the current SA Power Networks determination does) is potentially evidence of an "underlying inconsistency" that "would not be consistent with the efficient investment and efficient operation of an NSP". We endorse Sapere's recommendation that the AER investigate whether a potential cause of this problem is the very low allowed return on equity produced by the 2018 RoRI in the current market conditions.

Please contact [redacted] on [redacted] or at [redacted] if you wish to discuss further any aspect of our submission.

Yours sincerely

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Chief Executive Officer