energy networks association

23 October 2013

Mr Lyndon Rowe
Chairman
WA Economic Regulation Authority
PO Box 8469, PERTH BC WA 6849

via email: publicsubmissions@erawa.com.au

Dear Mr Rowe

Supplementary Letter and Materials – Draft Rate of Return Guidelines

The Energy Networks Association (ENA) would like to make this supplementary submission to the Economic Regulation Authority (ERA) of Western Australia relating to the *Draft Rate of Return Guidelines* (draft guidelines) and accompanying *Explanatory Statement for the Draft Rate of Return Guidelines* released on 6 August 2013. The ENA also wishes to provide some comments that are relevant to this guideline development process.

The ENA notes that formal consultation on the draft guidelines closed on 19 September 2013 and this submission is made outside of the formal consultation process. However, we consider it important to bring to the ERA's attention substantial material that was provided to the Australian Energy Regulator (AER) with regard to its development of the equivalent guideline for the energy networks that operate in the National Electricity Market. Given significant overlap between the two concurrent processes, the ENA hopes that the ERA will take this material into account in finalising its draft guidelines.

Supplementary material for ERA's consideration

Attached is the ENA's full submission (Attachment A). In addition, expert reports are contained within Appendix D, Attachments 1-7 and 9-10. This material provides empirical evidence and expert advice in relation to the estimation of cost equity, cost of debt and value of imputation credits in the context of the revised *National Gas Rules* (NGR). The ENA's submission and associated attachments also address some of the AER's criticisms in relation to earlier submitted material. To the extent that the ERA might share some of these concerns, the provided material seeks to resolve them.

I note that Attachment 8, which contains a response to the AER's criticism of CEG's estimates of average term of debt at issue, is not provided with this submission as it contains confidential information of relevance to the AER's proposed cost of debt methodology. The conclusions drawn by this report, however, strongly support that the benchmark term of debt at issuance should be at least 10 years. The ENA is in a position to seek members' permission to provide Attachment 8 to the ERA, should you consider that this material might be useful in finalising draft guidelines.

2013 Nobel Prize in Economic Science

The revised NGR require that regulators consider and utilise a range of estimation methods, financial models, market data and other evidence in determining the allowed rate of return. In relation to estimation of cost of equity, network businesses have been advocating that appropriate consideration and weight should be given to the Fama-French Three Factor Model. However, in their draft guidelines both the ERA and the AER rejected giving any weight to this model in deriving cost of equity estimates.

The ENA would like to draw the ERA's attention to the awarding on 14 October 2013 of the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel (commonly referred to as the Nobel Prize in Economic Sciences) jointly to Eugene F. Fama, Lars Peter Hansen, and Robert J. Shiller for their empirical analysis of asset prices.

The ENA considers that this recent development is relevant to consideration of Fama-French Three Factor Model and the role it should play in estimating the allowed return on equity. The background paper that was released with the announcement and explains the basis for the award provides a useful summary of Eugene Fama's contribution to studying how assets are priced. The paper discusses that the Fama-French Three Factor Model was developed to provide additional insights into behaviour of asset prices since the development of Sharpe-Lintner CAPM. Also, the paper notes that Fama-French Three Factor Model is commonly used by market practitioners in making important investment decisions, as well as in academic work. Therefore, the ENA is strongly of the view this and other asset pricing models discussed in the ENA's previous submissions should not be disregarded in the final guidelines.

Further details of this award, as well as a copy of the background paper, are attached to this letter (Attachment B and Attachment C).

Significant divergence in views between AER and ERA

The ENA notes that in their draft guidelines the AER and the ERA have proposed sharply different methodologies to estimating cost of equity and cost of debt, as well as the range of evidence and information that can be taken into account. The ENA considers such major differences in treatment of regulated rates of return can not be justified, especially given that both guidelines are being developed under the same rules.

The ENA has strong concerns in relation to the approach that the ERA has selected in its draft guidelines. In its current form, it appears to have a high risk of falling short of meeting the requirements of the revised rules' framework. The revised NGR require regulators to genuinely consider and weigh a broader range of estimation methods, financial models, market data and other evidence in determining the allowed rate of return. Therefore, the ERA's task is to demonstrate how it will utilise each relevant model and piece of evidence to derive an outcome which is consistent with the allowed rate of return objective.

Noting that there are a number of areas of disagreement between the AER and the ENA, we consider that the AER's draft guideline takes some positive steps towards incorporating a wider range of evidence in its decision-making process. By contrast, the ERA's proposed approach is almost identical to its current practice and does not appear consistent either with the intention of the AEMC or the requirements of the rules as currently drafted. The ENA urges that the ERA reconsider its approach to ensure its final guideline is more clearly consistent with the rules.

Yours sincerely

John Bradley

Chief Executive Officer