

NEW RATE OF RETURN GUIDELINES MEAN MORE STABLE ENERGY PRICES FOR CONSUMERS AND MORE STABLE RETURNS FOR NETWORKS

The Australian Energy Regulator has published new guidance on how it will determine the return that electricity and gas network businesses can earn on their investments.

The new approach has involved extensive consultation with businesses and consumers since the new network regulation rules were finalised in late 2012, and were developed as part of the AER's Better Regulation program.

"These measures will support continuing investment in essential services without requiring consumers to pay for excessive returns to network businesses. These changes are expected to result in lower and more stable allowed returns on equity on average than rates we have set in the past, depending on factors such as market conditions," AER Chairman Andrew Reeves said.

The new guideline describes the method for determining the allowed rate of return, based on the efficient financing practices of a benchmark network business. The return on investment can make up approximately 50 per cent of revenue needs for network businesses.

"The AER will analyse a variety of information sources on current market conditions and use well-tested financial models to estimate the allowed rate of return. This is critical in the capital intensive energy sector," Mr Reeves said.

"Prior to changes to the rules in late 2012, the process for setting the allowed rate of return was locked-in for some sectors of the energy market. This left little room for responding to changing market conditions and the allowed rate of return could not keep pace with the changes in the financing practices of the industry," Mr Reeves said.

"The AER was concerned that consumers were paying for excessive returns to network businesses and that there were significant fluctuations in the allowed rates of return over time. We expect our new approach to lead to more stable returns for businesses and prices for consumers," Mr Reeves said.

The AER recognises the importance of clarity and transparency in the regulatory process. Therefore our rate of return guideline sets out how we intend to use the various financial models and market data in determining the return on equity component of the rate of return. The guideline lowers the parameter, known as the equity beta, that measures the extent to which the return on equity for energy network businesses varies with market conditions in general.

On the return on debt, the AER proposes a significant change to the current approach of setting the debt allowance. The current approach set the allowance on the basis of a snapshot of current rates in the debt market taken once every five years. This led to a wide range of allowed rates of return, depending on when rates were set. The new approach will set the allowance on the basis that debt is raised incrementally over time, so that only a portion of the debt is refinanced annually. This new approach will lead to more stable allowed returns and price outcomes.

Applied consistently over time, the AER's guideline will provide greater regulatory stability and increased certainty through greater transparency of the key components of the rate of return and how these are assessed. It will allow the rate of return to change through time as

market conditions change. The AER's approach balances the interests of stakeholders while providing for the recovery of efficient financing costs, less cash flow volatility for the businesses, and more stable price movements for consumers. The framework will support the attraction of long term capital while addressing the long term interests of consumers.

BACKGROUND

The AER regulates energy markets and networks. It is an independent body under the Competition and Consumer Act 2010, and its functions are set out in national energy market legislation and rules.

The Australian Energy Market Commission (AEMC) finalised changes to the network regulation rules in late 2012. Shortly after, the AER began its Better Regulation program to consult on how it would conduct energy network regulation under the new rules. The AER's new approach is set out in a series of guidelines that form an integrated package of network regulation reforms.

Our new approach affects all energy network business, including the listed companies APA Group, DUET, Envestra, SP AusNet, and Spark Infrastructure.

In total the Better Regulation program included seven new guidelines and the Consumer Challenge Panel (appointed 1 July 2013) that will advise the AER on consumer interests in revenue determination processes. The new guidelines are:

- Regulatory Investment Test for Distribution (published 23 August 2013) establishes consistent, clear and efficient planning processes for distribution network investments in the national electricity market.
- Consumer engagement guideline (published 6 November 2013) sets out a framework for energy network businesses to better engage with consumers.
- Confidentiality guideline (published 19 November 2013) sets out how energy network businesses must make confidentiality claims over information they submit to us.
- Expenditure incentives guideline (published 29 November 2013) includes measures to give electricity network businesses incentives to spend efficiently and share the benefits of efficiencies with consumers.
- Expenditure forecast assessment guideline (published 29 November 2013) describes the process, techniques and associated data requirements for our approach to setting efficient expenditure allowances for network businesses.
- Shared assets guideline (published 29 November 2013) outlines how electricity consumers will share in the benefits when network businesses use the electricity assets consumers pay for to provide other services.
- Rate of return guideline (published 17 December 2013) sets out improvements to the way we determine the return energy network businesses can earn on their investments.

All the guidelines are accompanied by consumer focused factsheets which provide background on the role of each guideline and the key positions. Further information on [Better Regulation is available on the AER's website](http://www.aer.gov.au/Better-regulation-reform-program) at <http://www.aer.gov.au/Better-regulation-reform-program>.

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