

Proposal and Invitation for Submissions – Revised Rate of Return for second pricing period

Document Number: 42755487

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1. INTRODUCTION

As required under the Pilbara Networks Access Code 2021 (**PNAC**), Horizon Power is undertaking the process of public consultations for its access information pack for the second pricing period starting 1 July 2024.

Horizon Power has already completed the first round of consultation on its initial suite of updated materials (which had a 29 January 2024 submission deadline) (**Consultation 1**). Horizon Power intends to publish its final decision on the Consultation 1 documents on 1 March 2024, with the final version of the documents to be published on 1 April 2024.

This paper is a second tranche of consultation on this specific (**Consultation 2**), specifically focusing on the rate of return equity beta.

Horizon Power has received advice from a third party economic advisor (**Economic Advice**) recommending Horizon Power update certain parameters of the rate of return that we had not consulted on in our draft Tariff-Setting Methodology – in particular, the Economic Advice recommends an increase to the equity beta for a benchmark generic network operator. If applied, it would increase Horizon Power Network's rate of return and network tariffs for the second pricing period.

Horizon Power is now undertaking public consultation on this specific matter. See section 2 for more detail on the change proposed to the rate of return, and section 3 on how and when to make a submission.

2. RATE OF RETURN – EQUITY BETA

ERA's determination 2021

On 24 November 2021, the Economic Regulation Authority (**ERA**) determined the rate of return for the Pilbara Networks for the first pricing period. The ERA's approach was to begin with estimates of the gearing ratio and equity beta for a benchmark energy network and to then make adjustments for different debt capacity and systematic risk of Horizon Power (+0.1 increase in the equity beta) and Alinta DEWAP (+0.2 increase in the equity beta).

Since the ERA's 2021 Pilbara Networks Decision, two additional pieces of evidence have become available to the public:

1. The ERA published an updated set of estimates for a generic network business in its December 2022 Gas Rate of Return Instrument (RoRI); and
2. Additional market data through to the end of 2023 has become available.

In its 2022 Gas RoRI, the ERA revised its approach to estimating the gearing ratio and equity beta by introducing a set of international comparator firms, having previously relied on domestic comparators. However, the ERA concluded that this new evidence did not warrant any change to the gearing and beta estimates it adopted in its 2018 Gas RoRI.

Accordingly, the equity beta used to estimate the rate of return in the draft Tariff Setting Methodology, published as part of Consultation 1, was the same as for the first pricing period (0.8) - a 0.1 increase on the equity beta of 0.7 for a benchmark energy network.

However, the Economic Advice is that the available evidence supports an equity beta higher than the ERA's current allowance. In particular, the ERA's own set of evidence supports an equity beta for the benchmark energy network of 0.8 rather than 0.7. There are two primary reasons for its conclusions on this point:

1. The evidence supports an estimate materially above 0.7. For example:
 - (a) The ERA has published a total of 232 comparator beta estimates.¹ The mean of these estimates is 0.87. Only 27% are below the 0.7 figure adopted by the ERA and 73% are above;
 - (b) The mean beta estimates over the ERA's 5 comparator markets are all materially above 0.7;
 - (c) The mean beta estimates over the ERA's 49 comparator firms are all materially above 0.7; and
 - (d) The estimates that the ERA has reported for various markets are almost exclusively above 0.7. It is only the single comparator in New Zealand that has a beta estimate below 0.7.
2. Also, the ERA appears to rely equally on Ordinary Least Squares (OLS) and Least Absolute Deviations (LAD) estimates of equity beta. It can be argued that the OLS estimate is consistent with the definition of equity beta in the Capital Asset Pricing Model (CAPM), but the LAD estimate is not. In its view, there is a reasonable argument that OLS produces estimates of the CAPM beta whereas LAD does not. This would seem to suggest that a higher beta estimate is warranted.²

Based on the Economic Advice, we propose to apply the ERA's approach to estimating the rate of return in full, making a single change – we propose to adopt an equity beta of 0.8 rather than 0.7 for the benchmark energy network, consistent with the Economic Advice on the available evidence. In all other respects, we propose to adopt the ERA's approach and parameter estimates.

This increase in the 'starting point' equity beta results in an increase in the equity beta estimate for Horizon Power to 0.9. This will increase the real pre-tax rate of return for Horizon Power Network from 4.85% to approx. 5.30%.

3. MAKING A SUBMISSION AND NEXT STEPS

Horizon Power has prepared and published this Additional Proposal and Invitation for Submissions to undertake the 'standard consultation process' (as set out in Appendix 1 of the PNAC) on the matter outlined above prior to Horizon Power's new pricing period commencing on 1 July 2024. Submissions on this paper are separate to the submissions received on the Consultation 1 documents (i.e. this is NOT an extension of the public consultation period for the Consultation 1 documents).

¹ 58 comparator businesses, OLS and LAD beta estimates, data periods of 5 years and 10 years.

² Frontier Economics, Updated gearing and beta parameter estimates, January 2024.

Submission format

Submissions on this paper must be sent via email to Pilbara@horizonpower.com.au by 5:00pm (Perth, Western Australia) Monday 19 February 2024 with the email subject line 'Revised Rate of Return Consultation– Second Pricing Period' in any format and include company name, contact name and contact details.

Key dates

Stages of Consultation Process		Date
First round public submission		
1.	Horizon Power publishes this Additional Proposal and Invitation for Submissions	5 February 2024
2.	Deadline for submissions	5:00pm, Monday 19 February 2024 Perth, Western Australia
Final Decision		
3.	Horizon Power publishes final decision on the Consultation 1 documents and this additional matter ³	Friday 1 March 2024
First Publication		
4.	Horizon Power publishes final version of the documents	By Monday 1 April 2024

Horizon Power may, at its discretion:

- alter the key dates for Stages 2 or 3 (above) at any time subject to the minimum timeframes; and
- make a 'draft decision' and undertake 'second round public submissions' as, set out in Appendix 1 of the PNAC, in which case Horizon Power will publish revised key dates on its [website](#).

³ As Consultation 2 focuses on a single parameter change with associated justification, the consultation period allowed is less than afforded for Consultation 1.