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Dear Ms Goldwater

Public inquiry into final access determinations for fixed line services—primary prices

I refer to Telstra's submission in response to the ACCC’s draft decision on primary price terms dated 1 May 2015.

As explained in that submission, Telstra considers that the ACCC's estimate of the market risk premium (**MRP**) does not reflect prevailing market conditions. The ACCC's estimate is out of step with current empirical evidence and the views of other regulators, particularly the Australian Energy Regulator (**AER**).

This is reinforced by a recent set of decisions by the AER published the day before Telstra's submission to the ACCC. In ten decisions published on 30 April 2015, the AER adopted a MRP estimate of 6.5 per cent.[1] Further, Telstra considers that the evidence presented by the AER in these decisions indicates that its estimate is highly conservative - the evidence indicates that, if anything, 6.5 per cent is likely to understate the current MRP.

As the ACCC would be aware, the AER principally relies on three sources of evidence in relation to the MRP - estimates of the historic average excess returns, estimates of the current MRP from dividend growth modelling (**DGM**) and survey results. As explained in Telstra's submission, we consider that there are limitations associated with use of historic average excess returns and survey results to estimate the current MRP, particularly in market conditions such as the present. In particular:

- Relying on historic average excess returns implies an assumption that the current MRP is close to its long-term average. While such an assumption may be reasonable in average market conditions, it is not reasonable where there is evidence of an unusually high or low appetite for risk.

- Survey results should be interpreted with a high degree of caution. This is particularly so where it is not clear what questions have been asked, or where the survey has been limited to just one parameter. As the Australian Competition Tribunal has observed,

[1] Final decisions for each of the NSW electricity distribution businesses (Ausgrid, Endeavour and Essential Energy), TransGrid, Directlink and TasNetworks, and ‘preliminary’ decisions for Ergon, Energex and SA Power Networks.

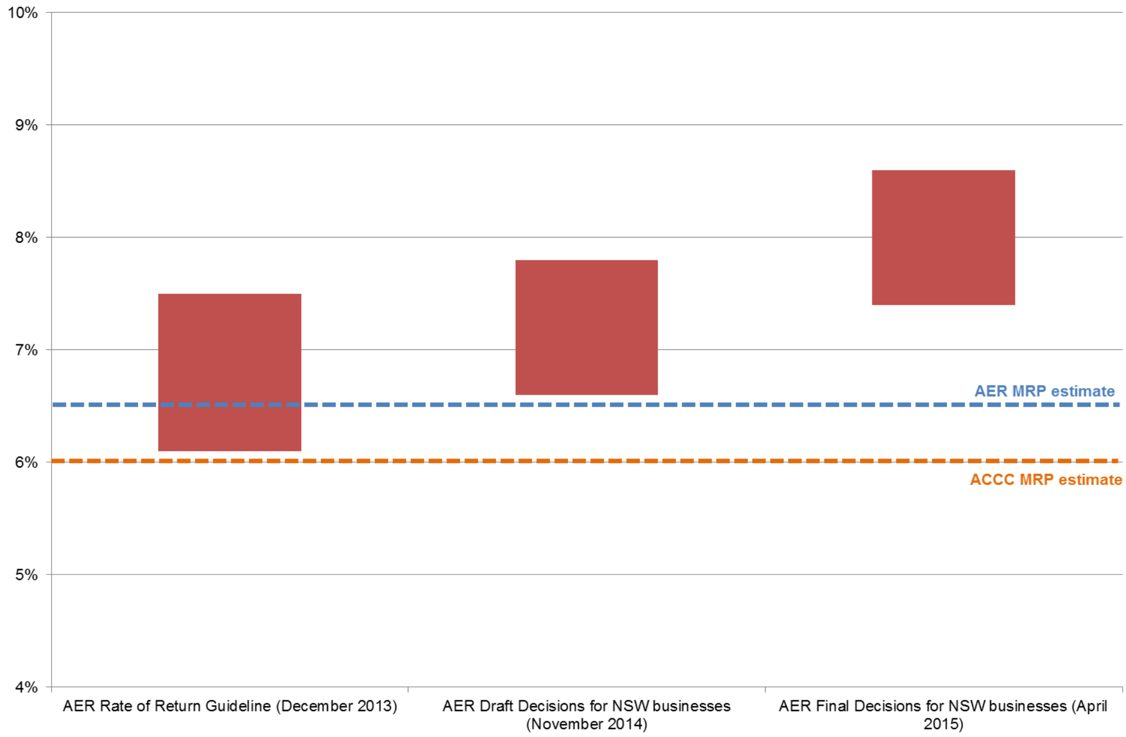
problems with the types of questions asked or the sample of respondents can lead to survey results being largely valueless or potentially inaccurate.[2]

Telstra considers that in market conditions such as the present, the best evidence of the current MRP is provided by DGM analysis. DGM results provide an indication of returns currently required by investors, as reflected in current equity prices and dividend yield forecasts.

As the ACCC would be aware, the AER has developed its own DGM, and regularly uses this to produce estimates of the current MRP. Over the past 18 months, as the risk-free rate has declined, the AER's DGM estimates of the MRP have increased significantly.

In the AER decisions published on 30 April 2015, the AER estimates a range for the MRP of 7.4% to 8.6% using its DGM.[3] This is significantly higher than its estimates from November 2014 and higher again than the estimates published in its Rate of Return Guideline (December 2013).

Figure 1: AER DGM estimates of the MRP[4]



This is clear evidence that the MRP has increased in recent months as the risk-free rate has declined. As noted by the AER, current DGM estimates support an MRP point estimate above 6.0%.[5]

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[2] *Application by Envestra Limited (No 2)* [2012] ACompT 3, [165]-[166].
[3] AER, *Final Decision: Ausgrid distribution determination 2015−16 to 2018−19, Attachment 3 – Rate of return*, April 2015, [3-310].
[4] AER, *Better Regulation - Explanatory Statement: Rate of Return Guideline*, December 2013, Appendix E, p 119; AER, *Draft Decision: Ausgrid distribution determination 2015−16 to 2018−19, Attachment 3 – Rate of return*, November 2014, [3-229]; AER, *Final Decision: Ausgrid distribution determination 2015−16 to 2018−19, Attachment 3 – Rate of return*, April 2015, [3-310].

This evidence also suggests that the required market return (the risk-free rate plus the MRP) has not fallen in perfect lock-step with the risk-free rate. The evidence referred to above indicates that the decline in the risk-free rate in recent months has been at least partially offset by an increase in the MRP.

The ACCC's position in the Draft Decision is inconsistent with this evidence. Contrary to the evidence from the AER's own DGM, the ACCC has assumed that:

- the MRP has remained at 6 per cent, and has not increased *at all* as the risk-free rate has declined; and
- the required return on the market portfolio (the risk-free rate plus the MRP) has fallen in lock-step with the risk-free rate.

The recent evidence from the AER's DGM analysis clearly refutes both of these assumptions.

In these circumstances, Telstra considers that it would be unreasonable for the ACCC to maintain an MRP of 6 per cent in determining prices for the declared fixed line services. The evidence supports an MRP of at least 6.5 per cent.

Please contact Alister Montgomery or myself if you would like to discuss this matter further.

Yours sincerely,

Jane van Beelen
Executive Director – Regulatory Affairs
Corporate Affairs

[5] AER, *Final Decision: Ausgrid distribution determination 2015−16 to 2018−19, Attachment 3 – Rate of return*, April 2015, [3-119].