



Online forum Rate of return working papers

Overall Rate of return

Warwick Anderson, GM Network Pricing

4 August 2021, 2.00 pm to 4.30 pm

Agenda

Time	Duration	Item	Presenter
2:00	5 min	Check in period	
2:05	5 min	Welcome and Introduction	Warwick Anderson (Chair)
2:10	15 min	Overview of working paper	Eric Groom, PSM, AER Board member
2:25	40 min	Stakeholder Presentations	ENA, NICE
3:05	10 min	Break	
3:15	40 min	Stakeholder Presentations	APGA, CRG
3:55	30 min	Other presentations and questions	
4:25	5 min	Next steps	Warwick Anderson

Context and background

- Working paper program so far:

	Title	Draft paper	Forum	Subs close	Final paper
<i>2020 working papers</i>					
1	Energy networks debt data	26 Jun	29 Jul	14 Aug	18 Nov
2	International regulatory approaches to rate of return	27 Aug	16 Sep	9 Oct	16 Dec
3	Capital asset pricing model and alternative return on equity models	27 Aug	16 Sep	9 Oct	16 Dec
<i>2021 working papers</i>					
4	Term of the rate of return	21 May	15 Jun	2 Jul	Sep
5	Rate of return and cashflows in a low interest rate environment	21 May	23 Jun	2 Jul	Sep
6	Overall Rate of return	15 July	4 Aug	27 Aug	Nov
7	Debt Omnibus	15 July	9 Aug	27 Aug	Nov
8	Equity Omnibus	15 July	11 Aug	27 Aug	Nov

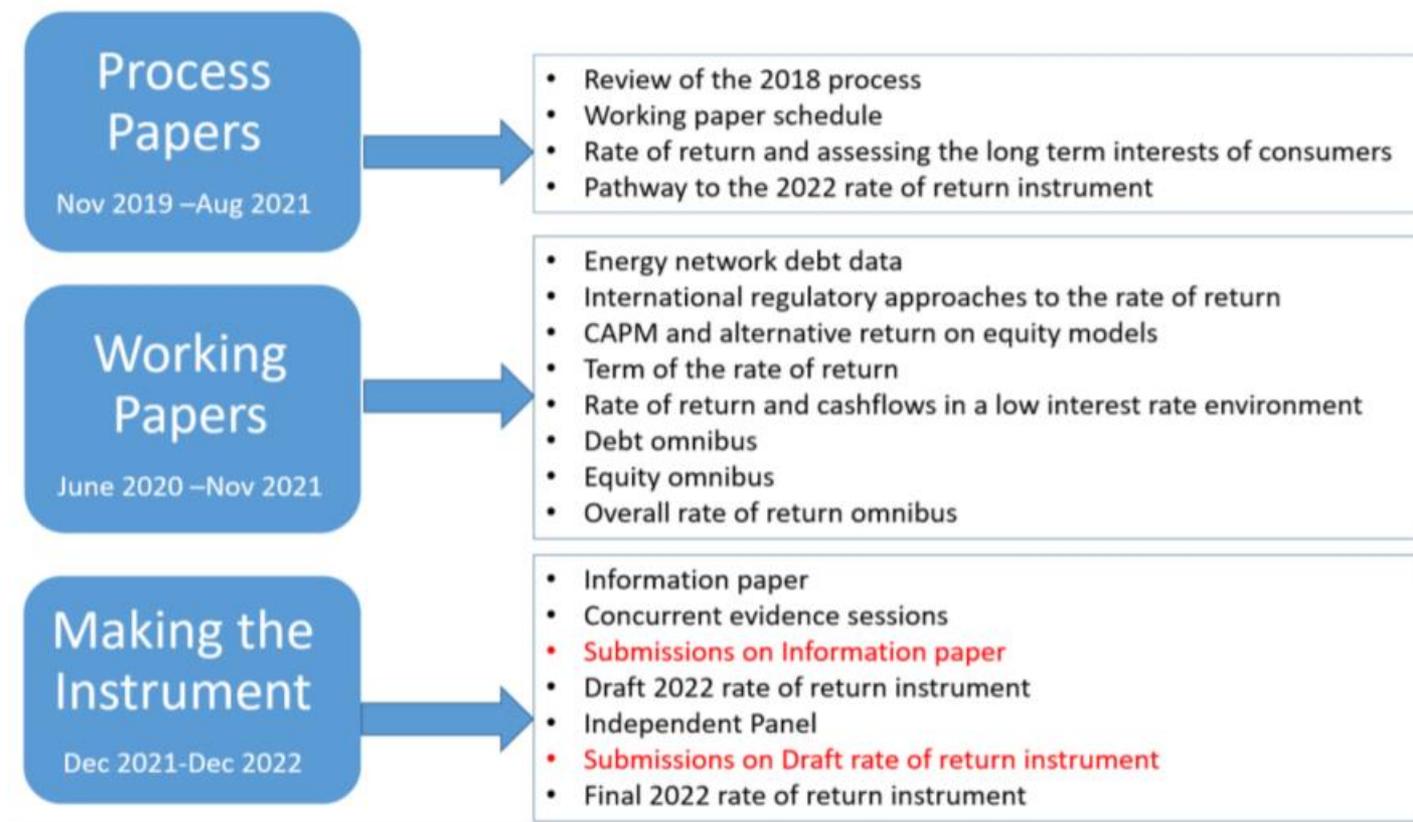
Overview of the working paper

Eric Groom, PSM, AER Board member

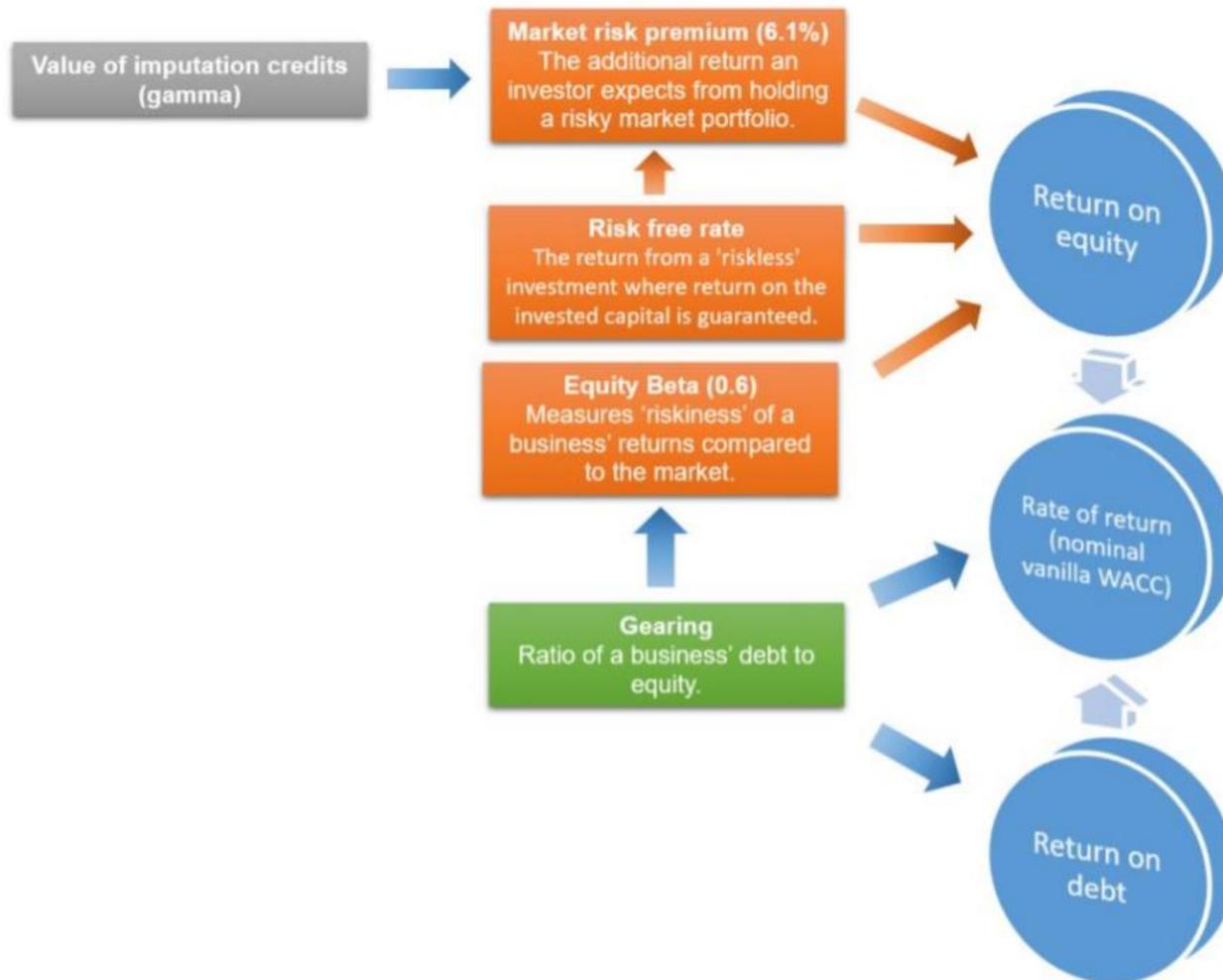
The Overall Rate of return draft working paper

- Briefed stakeholders on 19 July 2021
- Split into Part A and Part B
 - Part A: overview of our process and frameworks
 - Part B: issues that were not captured in other working papers
- Hear stakeholders' initial thoughts on key topics in the paper

Part A - Elements of the Pathway to 2022



Part A – Overview of the rate of return framework

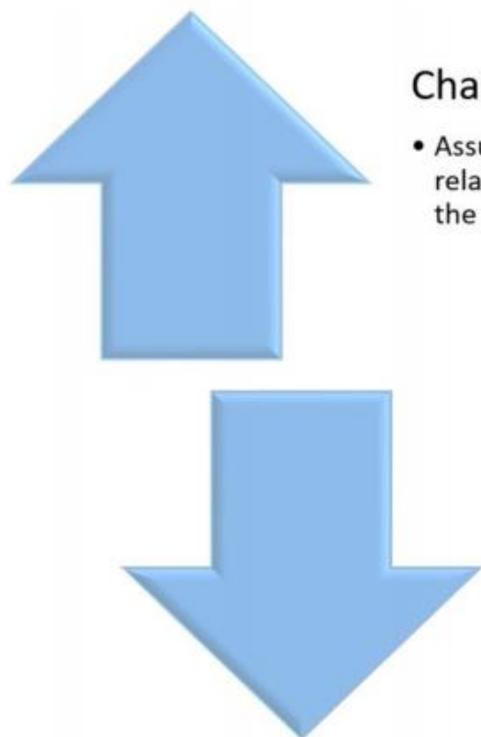


Part A – Overview of working paper series

Working Paper	2018 Instrument position	Current Position
<i>Energy network debt data</i>	Use the EICSI as a cross-check for benchmark credit rating	EICSI is to be used directly to determine the benchmark blend of A and BBB bonds
	Use the WATMI as the floor of possible options for the benchmark term	An updated WATMI, combined with the more detailed drawdown data, may be useful in determining a benchmark term
<i>International regulatory approaches to the rate of return</i>	Review of instrument to be held every five years consistent with legislation. Annual updates to be undertaken annually.	Review of instrument to be held every four years consistent with legislation. Annual data updates published.
	Set the risk-free rate only at the beginning of each reset period	Set the risk-free rate only at the beginning of each reset period
	Make no adjustments for expected incentive scheme outcomes	Make no adjustments for expected incentive scheme outcomes
<i>CAPM and alternative return on equity models</i>	Standard Sharpe-Lintner CAPM model used as the basis for determining the return on equity	Standard Sharpe-Lintner CAPM model used as the basis for determining the return on equity
<i>Term of the rate of return*</i>	The term of equity and debt were of ten-year duration	It is unnecessary to align the term of equity, debt and expected inflation
	10-year term for return on equity, consistent with life of underlying asset	Ten-year term consistent with existing practice or five-year term for return on equity, consistent with length of the regulatory period
	Return on debt determined through a trailing average approach	Return on debt determined through a trailing average approach
	Ten-year term for return of debt	Match the term of the return on debt to that of an efficient firm's borrowing

Part A - Potential impact on the rate of return

- At this time, there are only a small number of areas that we consider may warrant change from the respective positions taken in the 2018 instrument



Changes that may raise ROR

- Assume existence of a negative relationship between the risk-free rate and the market risk premium

Changes that may lower ROR

- Change the term of equity to match the length of the regulatory period
- Use the Energy Infrastructure Credit Spread Index to set the cost of debt

Part A – Decision making framework

- Same criteria: 2013 Guidelines => 2018 Instrument => Now
- Assess possible changes by:
 - scope all components of the rate of return for potential change
 - assess the relative merits of new evidence
 - set out thinking (and preliminary positions)
 - being open to engage with stakeholders
- Consistency over time is important
 - 2018 Instrument is an initial reference point

Part B

- Explore topics that needs to be considered but are not covered by other working papers.
 - The form of the rate of return
 - The benchmark gearing level and the treating of hybrid securities
 - The data used to inform gamma
 - The possible use of cross checks and scenario testing

Part B - Form of the rate of return

- Maintain a nominal vanilla WACC
 - simple and transparent
 - consistent with our estimation of the value of imputation credits
 - consistent with our long-standing approach

Part B - Gearing

- Preliminary view is to adopt a benchmark gearing value that more closely aligns with our market value estimates
 - Updated empirical gearing estimates indicate grounds for a 55% value
 - A lower gearing would likely affect other parameters

	2018 RORI	2019 Update	2020 Update
Market gearing: 5 year average	54%	53%	52%
Market gearing: 10 year average	60%	57%	55%
Book gearing: 5 year average	69%	69%	71%
Book gearing: 10 year average	70%	69%	70%

- We are considering the treatment of hybrid securities when estimating gearing

Part B - Gamma

- Propose to continue using the 2018 methodology
 - **distribution rate:** reliance on the top-50 ASX listed firms' annual reports
 - **utilisation rate:** reliance on equity ownership information (based on ABS wealth data)
 - subject to findings from the December 2018 ATO note and any updated data
 - currently considering if non-resident investors assign a material value to imputation credits

Part B - Overall cross checks and scenario testing

- Seeking views on the possible use of cross checks
 - Historical profitability and RAB multiples
 - Investment trends
 - Financeability metrics
- Considering the possibility of scenario testing
 - Convincing case needs to be put forward
 - Proper implementation may be complex

Key questions

1. should a nominal vanilla WACC be used to estimate the allowed rate of return?
2. what is the appropriate approach for estimating gearing?
3. what is the appropriate value for benchmark gearing
4. what is the appropriate treatment of hybrid securities in the gearing estimation methodology?
5. should the data used to inform gamma in the 2018 Instrument continue to be used?
6. is the data in the ATO's December 2018 note suitable for informing the utilisation rate?
7. should non-resident investors be assumed to derive no value from imputation credits?
8. how can crosschecks be used to inform the overall rate of return?
9. can scenario testing be used to inform the overall rate of return?

Stakeholder presentations