AUSTRALIAN ENERGY REGULATOR

Public Forum Draft Rate of Return Instrument

July 2022

Eric Groom, AER Board member

Acknowledgment of Country

Purpose of briefing

- Brief stakeholders on:
  - Key points of our draft Instrument decision
  - Our approach and rationale to arrive at our draft Instrument decision
- Submissions and next steps
  - Process to make our final Instrument decision
  - Independent Panel
  - How stakeholders can have their say
- Consumer and industry stakeholders' presentation of views on draft Instrument

	Duration	Item	Presenter
1:55	5 min	Check in period	
2:00	5 min	Welcome and introduction	Warwick Anderson (Forum Chair)
2:05	25 min	Overview of draft decision	Eric Groom, AER Board member
2:30	10 min	Q&A	
2:40	15 min	Stakeholder presentation	ECA - Lynne Gallagher
2:55	15 min	Stakeholder presentation	ACOSS - Kellie Caught
3:10	5 min	Stakeholder presentation	AEC - David Markham
3:15	10 min	Q&A	
3:25	15 min	Stakeholder presentation	ENA – Charlotte Eddy (Ausnet) and Garth Crawford
3:40	15 min	Stakeholder presentation	CRG - Bev Hughson
3:55	15 min	Stakeholder presentation	APGA - Nick Wills-Johnson
4:10	20 min	Q&A	
4:30		Concluding remarks	Warwick Anderson

Draft Rate of Return Instrument – key features

- Our draft Instrument is largely consistent with the 2018 Instrument, with only one substantive change.
  - Term of the return on equity (or term of the risk-free rate) is changed from 10 years to a term matching the length of the regulatory period (typically 5 years).
- We have maintained our 2018 approach to estimating MRP, which is to set the MRP based on estimates of historical excess returns.
- To ensure consistency with the term of the risk-free rate, we set 4 MRP values in our draft decision based on the length of the applicable regulatory period.
- In accordance with our annual data update, we have updated the data used to inform the Instrument and this has resulted in a higher value for the MRP.
- While we said we would maintain our 2018 approach to estimating MRP, we highlighted that we were open to considering an alternative subject to submissions.

- Smaller changes to our draft Instrument/approach include:
  - Averaging periods are shifted forward by one month to allow more time for resets and pricing.
  - We excluded hybrid securities from our gearing estimation, though this did not change its value.

Draft Rate of Return Instrument – indicative values

Parameter	2018 Instrument (February)[1]	2022 Instrument (February)[1]	2022 Instrument (April)[2]	2022 Instrument (June)[2]
Indicative rate of return	4.71%	4.76%	5.88%	6.91%
Gearing ratio	0.6	0.6	0.6	0.6
Indicative return on debt[3]	4.00%	4.00%	5.23%	6.44%
Indicative return on equity	5.78%	5.90%	6.86%	7.62%
Market risk premium	6.1%	6.8%[4]	6.8%[4]	6.8%[4]
Equity beta	0.60	0.60	0.60	0.60
Indicative risk free rate	2.12% (10-year)	1.82% (5-year)	2.78% (5-year)	3.54% (5-year)
Value of imputation credits	0.585	0.585	0.585	0.585

1. Indicative rates are based on market rates for the risk-free rate and return on debt over February 2022 (20-day average).
2. Indicative rates are based on market rates for the risk-free rate and return on debt ending 29 April or 30 June with a 20-day average
3. Indicative rates are based on 'on-the-day' return on debt estimates and do not reflect a trailing average (we note that service providers are currently at different stages of transitioning to the trailing average).
4. For a five-year period. Historical excess returns are averaged to the most recent full calendar year – 2021.

Road to draft Instrument decision - 6 key topics

- 2020 and 2021, we reviewed and consulted on the rate of return through a series of Working Papers.
- Information Paper published December 2021 outlined 6 key topics to resolve.
- Taking into account expert discussions in the Concurrent Evidence Sessions in February 2022 and stakeholder submissions, we have landed a position on each topic in our draft Instrument decision.
- Six topics are:
  - Term of the risk-free rate (term of equity)
  - Market risk premium (MRP)
  - Equity beta
  - Use of our industry debt Index
  - Weighted trailing average return on debt
  - Crosschecks of the rate of return

6 key topics – Term of the risk-free rate

- Our draft decision is to change the equity term to match the length of a regulatory control period.
  - We set a revenue allowance for one regulatory period at a time. This practice affects the regulatory cash flows and risk profile of regulated assets and the expected return investors require.
  - Equity term matching the length of the regulatory period better aligns with the risks borne by the investors.
  - Using an equity term that does not match the length of the regulatory period, means the zero net present value condition is not met and investors are not correctly compensated for risk.
  - An equity term longer (shorter) than the regulatory period results in consumers paying above (below) the efficient costs under a normal yield curve.
  - We consider the change meets the required bar for change, because it will both better achieve the NPV=0 condition and also bring consistency to our approach.
- We acknowledge arguments have been put forward to maintain our current approach.

6 key topics - MRP

- Our draft decision is to maintain our current approach for estimating MRP, though the term has been changed to be consistent with the length of the applicable regulatory control period.
  - This entails setting four fixed values of the MRP for different terms in the Instrument based on the estimates of historical excess returns (HER).
- Whilst we are proposing this approach, we recognise another option would be to:
  - Specify a formula for calculating the MRP at each point in time when we make each regulatory determination over the life of the Instrument (option 3b).
  - In summary, the formula is the most recent estimate of HER (50%) plus the most recent estimate of the MRP from our 3-stage DGM employing a variable growth rate (50%).
- We have explored the merits of both approaches.
  - While we prefer to continue our current approach, we have explained how the alternative option could be incorporated in the Instrument including the relevant formulae and data series.
  - This detail will enable stakeholders to engage more deeply with the options and be able to provide comments on the mechanics of each approach.

6 key topics – Equity beta

- We maintain our overall approach from the 2018 Instrument, including:
  - placing most weight on the longest period estimates, while also being informed by 5-year estimates
  - maintaining the existing comparator set of 9 Australian firms, and not including international energy firms or domestic infrastructure firms in our comparator set
  - setting a single beta for regulated gas and electricity networks

- We maintain our existing comparator set
  - There are significant differences between int'l firms and the benchmark Australian regulated energy network.
  - We consider that our existing comparator set remains appropriate for the time being.
  - We recognise that in the future we may need to develop a revised approach.
- Our draft decision is to apply a point estimate of 0.6.

6 key topics – Use of our industry debt index

- Our draft decision is to continue collect data and monitor EICSI as a ‘sense check’ – no adjustment to return on debt approach for term, credit rating or residual outperformance.
- We do not consider current data suggests the observed outperformance is material and persistent.
- Evidence suggests current approach is generally reflective of expected debt costs.
- We acknowledge term appears to be a key driver of observed outperformance. We do not consider there is sufficient evidence 10 years is no longer an appropriate debt benchmark across industry.
- Practical limitations to implementing an adjustment to term to reflect results of the EICSI.
- We will continue to collect industry debt data and monitor EICSI against our benchmark approach.

6 key topics – Weighted trailing average

- Our draft decision is to retain the status quo by continuing the (simple) trailing average approach. This is because:
  - For the majority of businesses, a weighted trailing average would not result in a materially different outcome.
  - For new businesses, the current transition arrangements would partly address potential mismatch.
  - Uncertainty whether a benchmark business would increase debt raising significant beyond 10% in a year.
  - Practical challenges to calculating the weights, which may decrease its ability to reduce any mismatch between the cost of debt and return on debt allowance.

- We intend to revisit this issue in our 2026 Instrument review.

6 key topics – Crosschecks

- Our draft decision uses crosschecks:
  - as a sense check of our overall allowed rate of return
  - to assist with identifying potential issues
  - not in a formulaic way to determine the overall rate of return
- We found most useful crosschecks to be:
  - RAB multiples (we welcome stakeholder views on the recently published CEPA report)
  - Financeability tests
  - Sensitivity and scenario testing
- Given these crosschecks our 2022 draft decision on the overall rate of return appears reasonable.

Other topics – Gearing

- We maintain our overall approach from the 2018 Instrument, including:
  - preference for use of market values to calculate gearing
  - the comparator set (note future change may be required)
  - regard to longer-term average (15 years), consistent with equity beta

- Gearing estimation excluded all hybrid securities, this is:
  - similar to splitting the hybrid security 50/50 between debt/equity as ratings agencies do, and
  - because sensitivity analysis shows the minimal impact on overall assessment of gearing for excluding or including as debt (56% vs 54% at 10y)

- Our draft decision is to maintain the 60% gearing value.

Other topics – Imputation tax credits (gamma)

- We maintain our approach from the 2018 Instrument, which estimates gamma as the product of:
  - the distribution rate – the proportion of imputation credits generated that is distributed to investors (estimated based on data from the financial statements of the top 50 ASX listed firms)
  - the utilisation rate – the utilisation value to investors in the market per dollar of imputation credits distributed (estimate based on the equity ownership approach using ABS data)
- Draft decision maintains gamma value of 0.585
  - Product of distribution rate of 0.90 and utilisation rate of 0.65.
- We do not give weight to ATO data when estimating the utilisation rate.
- We maintain our assumption that non-resident investors derive zero value from imputation credits.

Averaging Periods

Risk-free rate and return on debt nomination windows:

- For our 2022 Instrument our draft decision is to modify the start and end dates of the nomination window.
  - Return on debt – starts no earlier than 17 months before (previously 16 months) and ends no later than 5 months before (previous 4 months) the start of the relevant regulatory year.
  - Risk-free rate – starts no earlier than 8 months before (previously 7 months) and ends no later than 4 months before (previously 3 months) the start of the relevant regulatory year.
- We require that a nominated averaging period must start and end between 8 months and 4 months prior to the commencement of the regulatory control period.

Timing issue:

- The 2022 Instrument will apply to a number of businesses that are required to submit their regulatory proposals, including their nominated averaging periods, before the making of the 2022 Instrument – creating a timing issue.
- For the impacted businesses, our draft decision is to apply the 2018 Instrument nomination window.

Process to make our final Instrument decision

Milestone	Date
Draft 2022 rate of return Instrument released	16 June 2022
Public forum on draft Instrument	**27 July 2022**
Release of Independent panel's report	Late-July/early-August 2022
Submissions on draft Instrument close	2 September 2022
Second public forum on draft Instrument	7 September 2022
Final Instrument published	16 December 2022 – applies to regulatory determinations made after this date.

Independent panel

- Independent Panel is currently reviewing our draft decision

- The Independent Panel were asked two questions:
  1. In the Panel's view, is the draft Instrument supported by evidence and reasons, taking into account competing factors such as accuracy, consistency, accessibility and transparency?
  2. In the Panel's view, is the draft Instrument likely to contribute to the achievement of the National Electricity Objective and National Gas Objective?

- Independent Panel review report will be published in the near future

How you can have your say

- Submission process:
  - The Independent panel has 6 weeks to review the draft Instrument and publish their report (July/August 2022)
  - Stakeholder submissions are due by **5pm AEST on Friday 2 September 2022**
  - We prefer that all submissions are in Microsoft Word or another text readable document format.
  - Submissions should be sent to: **rateofreturn@aer.gov.au**

- There will be a second public forum in September.
  - We invite interested stakeholders to talk through their submissions on the draft Instrument
  - For us and other stakeholders to ask questions

- We will try to accommodate stakeholder requests for separate meeting, subject to the Board members' and staff's availability. Discussions and materials presented at these meetings will be published on our website.

Thank you

- For attendance this afternoon
- For your engagement and assistance in developing the draft Instrument
- We now hand the presentation floor over to consumer and industry stakeholders to present their view on our draft decision.

Organisation	Presenter
Energy Consumers Australia	Lynne Gallagher
Australian Council of Social Service	Kellie Caught
Australian Energy Council	David Markham
Energy Networks Australia	Charlotte Eddy (Ausnet) and Garth Crawford
Consumer Reference Group	Bev Hughson
APGA	Nick Wills-Johnson