AUSTRALIAN ENERGY REGULATOR

Draft decision: Rate of Return Guideline Review

About the rate of return guideline review

We are required to review the rate of return guideline every 4 years and are currently reviewing our 2013 Guidelines. The Council of Australian Governments, Energy Council is proposing to amend the legislation that governs the rate of return guideline. If the proposed legislation is made into law it will result in the 2018 Guidelines becoming binding for 4 years from its finalisation. This means our 2018 Guidelines must set the rate of return and value of imputation credits so that they can be automatically applied to regulatory decisions during the next 4 years.

In coming to this draft decision we have extensively engaged with stakeholders and also incorporated new processes. These are:

- We established a consumer reference group to provide submissions and input into the process
- We published discussion papers on a range of key topics to assist stakeholders make submissions
- We held two concurrent expert evidence sessions to hear expert opinions on a range of key topics
- We have also established an independent panel that will produce a report on our draft decision

What is the rate of return?

The allowed rate of return is an estimate of the appropriate cost of funds for investment in a network. The rate of return is multiplied by the regulatory asset base (all the regulated assets the regulated business owns) to arrive at the regulated business' required funds as return on capital investment. A good estimate of the rate of return is necessary to ensure efficient prices in the long-term interest of consumers.

We have three key components in the rate of return that have been reviewed in this draft decision.

- Return on Equity
- Return on Debt
- Imputation credits (gamma)

This approach using the above components to estimating the rate of return is consistent with our 2013 Guideline. Figure 1 gives a graphical representation of how these components are factored into the rate of return.

> Our draft decision uses the same set of components to derive a rate of return as our 2013 Guideline. However, we have reviewed how we derive these components.

How will we estimate return on equity?

The return on equity uses the Sharpe-Lintner Capital Asset Pricing Model. The parameters that factor into this model are:

- Equity beta
- Market Risk Premium (MRP)
- Risk Free Rate (RFR)

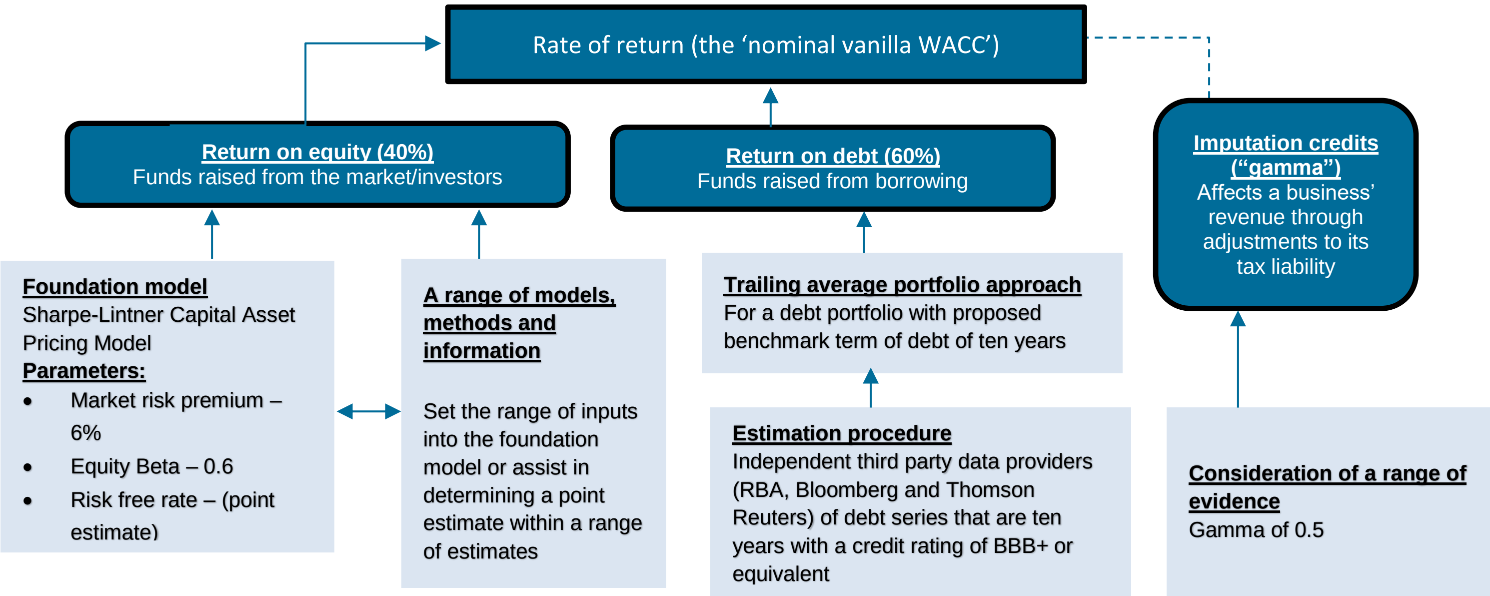
We have reduced the values for Equity beta and MRP relative to the 2013 guideline. This change is to reflect the current market conditions and recent analysis. Our analysis has shown that regulated business' face less risk than the overall stock market and therefore require a lower return on equity to attract investment.

In addition to this, we have allowed a longer averaging period for the RFR. This will allow regulated businesses to reduce their exposure to fluctuations in Government Bond yields, a benefit identified by networks, investors and consumers.

> Our draft decision reflects that the return on equity required to attract investment is lower than the rate applied in the 2013 guideline.

How will we estimate return on debt?

We propose to continue using our trailing average approach to estimating the return necessary for a regulated business to fund investments through debt. We have reviewed the appropriate debt series, credit rating, term of debt and choice of debt data series.



We have maintained our benchmark credit rating and term of debt, from the 2013 guideline. Our approach to the benchmark credit rating has been updated to more accurately reflect the appropriate rate. We also included an additional debt data series, the Thomson Reuters debt curve to be evenly averaged with the RBA and Bloomberg debt curves.

Our draft decision on the return on debt approach is largely consistent with our 2013 guideline and reflects similar market conditions. The changes we have made are in how we practically calculate these factors.

How will we estimate the value of imputation credits?

Investors value the tax credits created by regulated businesses when they frank their dividends. We reflect this value through the parameter represented by the Greek letter gamma.

We will employ a gamma value of 0.5. We arrived at this rate after analysing data provided to us by the ATO, Australian Bureau of Statistics and observing the distribution rate of the top 20 ASX-listed firms.

Our draft decision reflects our analysis of information provided by several data sources on the appropriate distribution and utilisation rates.

What are the next steps?

- We will host a public forum in early August to go through the draft decision.
- We have established an independent panel that will review the draft decision and produce a report on the process in mid-September.
- We request submissions on our draft decision and the independent panel report.
- Then we will publish the final decision in mid December.

How can I provide a submission or comments?

We invite interested parties to make submissions or comments on our draft rate of return guideline. If you would like to have your say prior to us publishing the final guidelines, you have until close of business **14 September 2018** to get your submission or comments to us. You can find further details on how to provide your submission on our web page, or you can email us at rateofreturn@aer.gov.au.