

Correspondence dated 13 February 2018 by Esmond Smith to CRG members

Dear All,

Below is information I indicated I would circulate related to our past commentary on DGMs. While I'm happy for this information to be circulated to others (including the rest of the CRG and CCP), It should be noted that no decisions have yet be made on how we may apply DGM models going forward.

AER staff commentary on DGMS

The AER has used DGMs to inform its estimate of the MRP. Evidence from the DGM was one piece of evidence the AER has used to inform it on where to set the MRP (as proposed in the 2013 Guideline in line with the 'foundation model' approach).

Contrary to what I said yesterday, the AER has not lessened the weight it has given to the DGM through time and I note in the recent decision for APA VTS in attachment 3 and p3-217 we stated: " We have not changed the weight we apply to the dividend growth model. Our approach requires the application of judgment and our market risk premium estimate does not mechanically update with changes to dividend growth model estimates." This statement was also made in our May 2016 decisions (e.g. see Attachment 3 to the final decision for Jemena distribution at p3-228).

In terms of concerns we have raised about the DGM in decisions since the 2013 Guideline, we have raised a number of concerns with the use of DGMs generally and these concerns have been supported in a number of expert reports:

- In the April 2015 Ausgrid decision attachment 3 available [here](#) we noted that DGMs are highly sensitive to assumptions and results, are sensitive to errors in analysts' forecasts (see pp 3-46 to 3-47 of AER Final decision attachment 3), and may generate volatile and conflicting results (p3-76). We also note that McKenzie and Partington considered our DGM was likely to produce upward biased estimates (see AER Final decision attachment 3 pp 3-47, 3-125 with references to the consultants reports).
- In the May 2016 decision Jemena attachment 3 available [here](#) we noted similar concerns (see AER attachment 3 final decision pp 3-204, 3-223, 3-226). A new report by Partington and Satchell available on the final decision web page support being cautious with your use of DGM estimates and their sensitivity to input assumptions (see pp 27-29 of their expert report). We also noted that a report referenced by Frontier could be evidence that the prevailing market is now more sceptical of analyst's forecasts than they have been in the past (attachment 3 p3-328). At pp 3-203 to 3-204 of the AER final decision Attachment 3 we also cited Associate professor John Handley's comments on the challenges of estimating the future growth rate of dividends in his 16 October 2014 report for the AER. Associated Professor Handley's report is available on the AER draft decision web page for Ausgrid [here](#) (see pp13-14 of Handley's report).
- In our most recent November 2017 decisions APA attachment 3 available [here](#) we noted similar concerns with DGM based estimates (see AER Final decision Attachment 3 pp 3-76, 3-80, 3-82, 3-84, 3-190)

Please note the above is sent purely to inform the ENA, CRG and CCP of some general concerns we have expressed through time with the DGM based estimates and their sensitivity to input

assumptions (as discussed I would circulate in the CRG/ENA meeting on 12 Feb 2018). It should also be noted that the references above are not all the commentary on dividend growth models in our decisions (which is fairly extensive).

Kind Regards, Esmond

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