Presentation to Public Forum
Rate of Return Guideline Review
Consumer Challenge Panel CCP16
Sydney – 2 August 2018

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Role of Consumer Challenge Panel

- The role of the Consumer Challenge Panel is to bring consumer perspective to the AER's decision-making
- CCP16 comprises David Prins (chair), Bev Hughson, Eric Groom, Louise Benjamin
- In this Rate of Return Review process, CCP16 has
  - Attended Concurrent Evidence Sessions
  - Written several formal submissions to the AER
  - Presented to the AER Board
  - Provided advice on the draft legislation to support a binding guideline

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Overview

- CCP16 supports the Draft Guideline
  - On the basis that it is a reasoned, proportionate (minimum) correction to
    - Reflect current market conditions
    - Address concerns that the rate of return was too high
- The Draft Guideline will stimulate highly technical debate
- Today we focus on the 'big picture', and consistency with
  - Regulatory principles and practice
  - Risks borne by networks
  - Market outcomes and conditions
  - Incremental review

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CCP16 preliminary views on the Draft Guideline

Consistent with NEO/NGO/RPP	Balanced outcome	✓
Incremental review	Overall framework remains Changes to confidence in models and supporting data	✓
Review process	Extensive stakeholder engagement Concurrent evidence sessions Independent review panel Appropriate engagement by AER with the material	✓
Overall return on equity	Overall reasonable and consistent with NEO/NGO/RPP	✓
MRP and equity beta	Improved balance	✓
Averaging period	Appropriate	✓

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CCP16 preliminary views on the Draft Guideline

Overall return on debt	Appropriate	✓
Weighted average A and BBB yields	Good development	✓
Addition of Thomson Reuters yield curve	Appropriate	✓
Overall value of imputation credits	Accepted – based on current data	✓
Overall capability of acceptance – whether as a guideline or as a binding instrument	**Any changes that the AER makes between draft and final should be to improve the long term interests of consumers**	✓

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Regulatory principles

Brown, Stern and Tenenbaum ‘Regulation Handbook’

Three meta principles

- ***Credibility*** – confidence that commitments will be honoured
- ***Legitimacy*** – fair: commercial return, with protection from excess profits
- ***Transparency*** – stakeholders know how decisions are made – now and in the future.

Credibility, legitimacy and transparency need to be considered in the overall regulatory and market context

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This is the strong perception of consumers – see CRG and previous CCP submissions

Applicable?
Yes

"Persistent high returns across all energy network companies threaten the credibility of the regulatory framework. In order to ensure that the regulatory framework continues to work in customers' long-term interests, Ofgem needs to respond to the lessons from RIIO-1. It needs to set a framework that provides customers wi
confidence that the network charges they pay reflect efficient costs, and that returns are justified and legitimate. This is also in network companies' and their investors' interest."

...to be sustain -able

Networks' interests are not served in the long term if it is not sustainable

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Assessing the Draft Guideline
(per CEPA report to Ofgem)

- Returns under the current regulatory framework and rate of return
- Market benchmarks and assessments
- RAB multiples
- Regulatory consistency

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Are current profits higher than they need be?

- Will know more when we see profitability review report
- In the meantime
  - CRG, CCP, and now ACCC have judged the overall framework generous
  - There is market evidence: RAB multiples support this assessment
  - Rate of return is aimed high (see submissions)
- The current regime looks low-risk / high-return
  - Asset protection and revenue caps mitigate risks
  - Information asymmetry offers upside, few downsides

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Do new risks warrant continuation of high returns?

- No.
- Technology risks are not systematic – don't belong in the equity beta
  - Technology 'risks' exist across all major industry sectors, and are captured in the MRP (banks, mining, ICT…)
  - The risk is in how each business manages new technology
- Given asset and revenue protection under the rules, new technologies may offer more upside than downside
  - Opportunities for improved efficiency
- Rules may change, but it is not for the AER to anticipate rule changes
  - Other protections / compensation may be added

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Market benchmarks

- Market benchmarks indicate that the required returns for these assets are lower than CAPM suggests in the current environment
  - E.g. Thames Tunnel bid WACC (real vanilla) of 2.497% was below Ofwat's guidance of 3.29%, and the latest WACC of 3.6%
  - RAB multiples for acquisitions also support this (see below)
- This discrepancy is not surprising
  - CAPM is a guide but not a precise tool, and financial markets are not perfectly efficient
  - May reflect supply and demand for low risk, growth assets

Effect of Draft Guideline on WACC and ROE

- Decision will reduce WACC by around 45 bp and ROE by 95 bp.

Year	2013 guideline-Dec 2013	2015 NSW Networks	2013 Guideline - Jun 2018	Draft 2018 Guideline
Inflation Rate	2.50%	2.38%	2.50%	2.50%
Value of Imputation Credits (gamma)	40%	40%	40%	50%
Risk Free Rate	4.24%	2.55%	2.64%	2.64%
Market risk Premium	6.50%	6.50%	6.50%	6.00%
Market ROE	10.74%	9.05%	9.14%	8.64%
Beta	0.70	0.70	0.70	0.60
Post-tax Nominal Return on Equity	8.79%	7.10%	7.19%	6.24%
Post-tax Real Return on Equity	6.14%	4.61%	4.59%	3.65%

Key change from 2013 is reduction in nominal and real bond rates

Underpinned NSW sales at high RAB X

Moderate tightening from 2015

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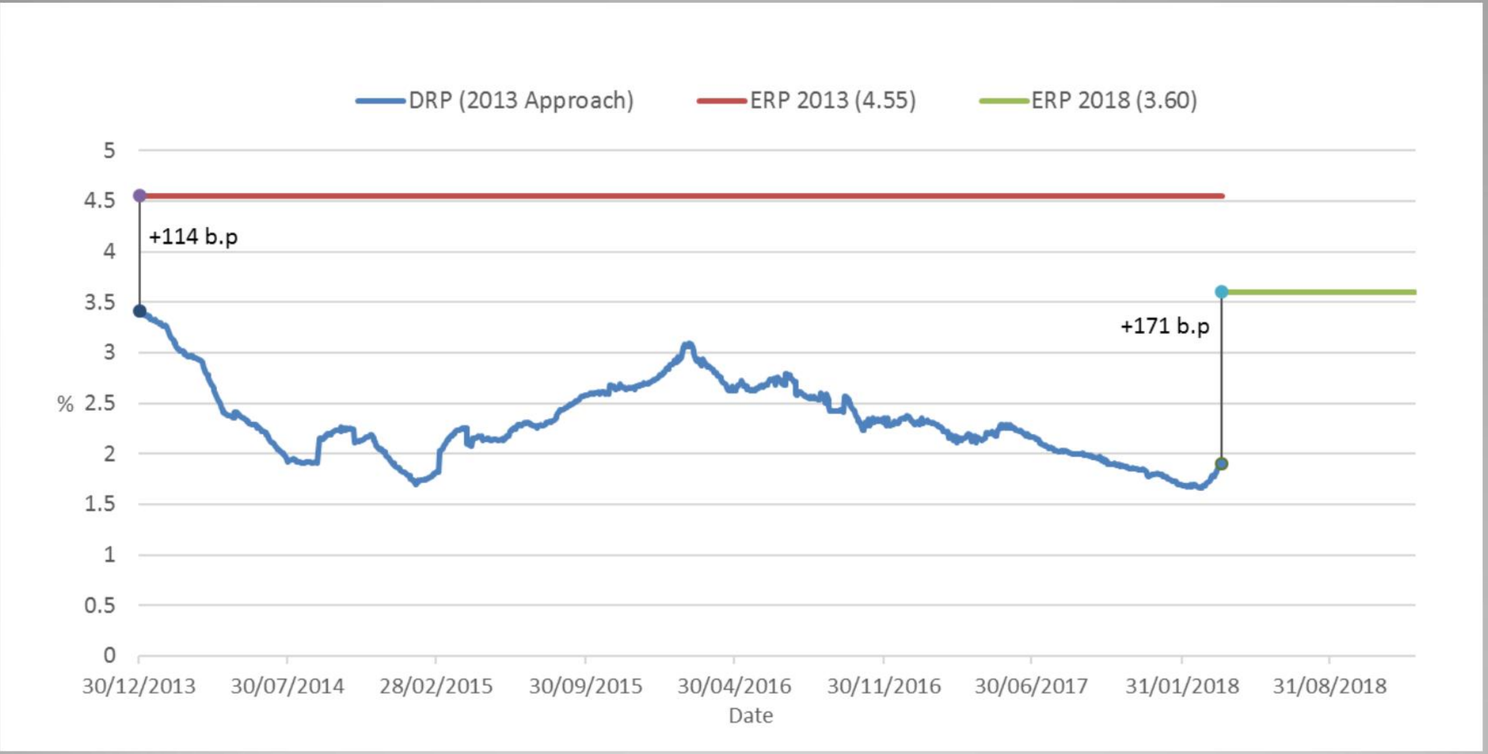
Margin to cost of debt is widening



Source: AER Draft Decision, p55

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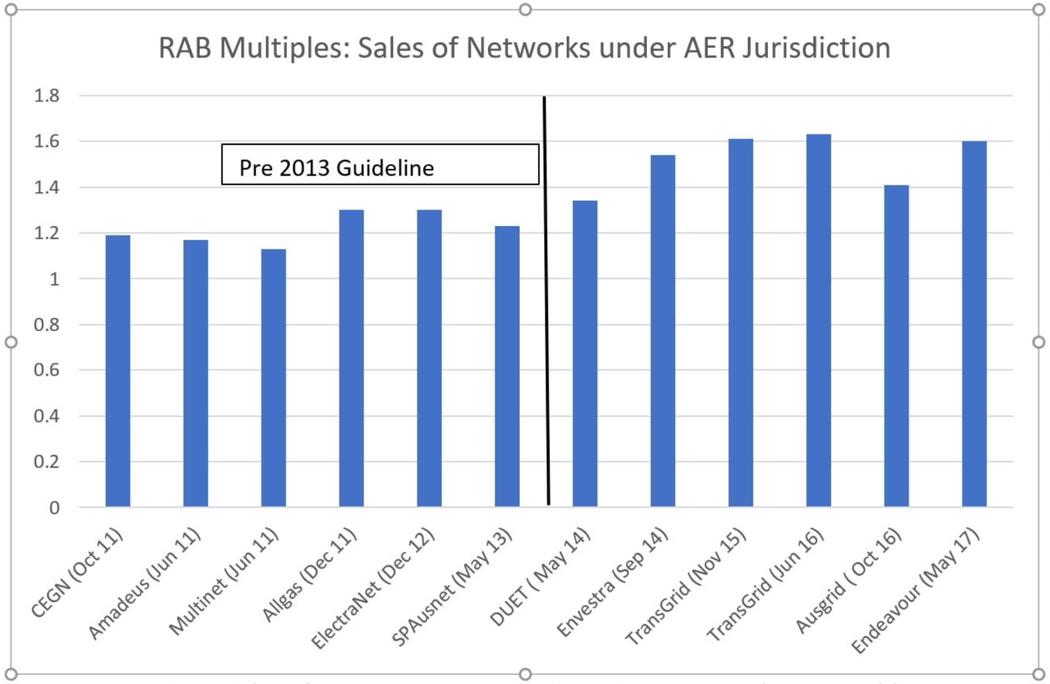
Investor analyst assessments

- Best characterised as mild surprise
  - Some reduction in MRP and / or Beta expected; perhaps not both
    - Partly foreseeable, however extent of ERP reduction in particular is likely to have exceeded expectations
    - MRP dropping back to 6% was not a surprise… but beta dropping to 0.6…
- Tightening of rate of return will affect asset values [unless it is argued that the rate of return does not have a significant discernible impact on RAB multiples…]
- However, preservation of high valuations is not an argument to maintain excess returns
- Broker valuations suggest RAB multiples would edge back towards more ‘normal’ levels

RAB multiples

- RAB multiples have been rising, and above benchmarks that typically raise concerns



Source: AER, Financial Performance Measures Discussion Paper, Feb 2018, Table 2, p 14.

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RAB multiples and excess returns

- Further analysis is required, but RAB multiples of 1.4-1.6 strongly suggest excess returns
  - In analysing gas transactions at a RAB multiple of 1.53, CEPA concluded: “our analysis suggests that investors may be willing and able to finance gas distribution assets at an actual cost of equity below the RIIO-ED1 allowance of 6.0%”.
  - CEPA estimated the implied ROE was between 3% and 6.3% (real)
- UK regulators (e.g. Ofwat and CEPA’s advice to Ofgem) use RAB multiples as an input to total market return estimate

Regulatory consistency

- Review is incremental; decisions well-supported
  - New data; changes in confidence in models; no change in overall approach
  - Some changes were already signalled in other recent decisions
- Reduction in MRP is supported by
  - Indicators of investment climate
  - RAB multiples
  - Relativity to debt
  - Increased questions re DGM, especially inconsistency with other data
- Reduction in beta is supported by
  - Analysis of link with ratio of regulated and unregulated income
  - Reduced confidence in Black CAPM and low beta bias theories
  - AER's preference for long-term 10-year data analysis consistent with approach across all other WACC parameters
    - Assessing beta over 5 years, but risk free rate over 10 years
    - Market volatility of 17%+ (Dimson et al) supports use of long-term data

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Returns in other regimes

- Other regulators are also reducing returns
  - Ofwat reducing rate of return from 3.74% to 2.4% (real, vanilla)
  - CAA reducing rate of return from 4.66% to 3-3.9% (real, vanilla)
  - Ofgem signalled reduction in ROE from 6-7% to 3-5%
- Real Total Market Return (TMR) is consistent
  - Draft Guideline real TMR = 6.15%
  - Ofwat proposed real TMR = 5.1- 5.5%
  - Ofgem (CEPA recommendation) = 5.0-6.5%

Value of imputation credits

- CCP supports AER's overall approach
- Agree with Lally's analysis & conclusions
  - Distribution ratio is a firm / industry specific parameter
  - Utilisation rate is a market wide parameter
- Imputation credit value of 0.5 is probably low
  - But given data limitations, accept AER's discretion on this
- Encourage AER to continue to further investigate:
  - Tax statistics data
  - Distribution ratios for the BEE (rather than top 20 ASX)
  - Networks credit distribution policies (e.g. distribution ratio > 1)
  - Impact of partial market segmentation vs. Officer CAPM assumption of fully segmented market

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