9 November 2022

Ms Clare Savage
Chair,
Australian Energy Regulator

Sent via email

Dear Ms Savage,

2022 Rate of Return Instrument Review – CEPA Report *EV:RAB Multiples*

Energy Networks Australia (**ENA**) welcomes the ongoing consultation process and constructive engagement with the AER Board and staff through the 2022 Rate of Return Instrument (RORI) review.

The AER has released an updated report by Cambridge Economic Policy Associates (CEPA) on the issue of RAB multiples. This follows the original May 2021 report that provided commentary on the role of RAB multiples and sought to estimate adjusted RAB multiples for Spark Infrastructure and AusNet Services on a disaggregated basis. Both reports consider inferences that might be drawn from these estimates for ongoing AER work on the RORI.

Updated CEPA Analysis

The update to CEPA's May report follows substantial stakeholder feedback raising fundamental issues with the analysis and assumptions underpinning the CEPA work.

ENA previously raised substantive concerns with the CEPA analysis. In our view, the updated analysis continues to exhibit fundamental analytical weaknesses. For example:

- **The central analysis continues to employ highly contested assumptions at odds with independent market evidence** – CEPA's base analysis continues to value the unregulated Development and Future Network (DFN) business owned by AusNet at 1 to 3 times historical revenue resulting in a mid-point value of $370 million, while taking as an 'upper bound' the central estimate reached by valuation firm Grant Samuel of $3,150 million, a value more than eight times higher.
- **The sensitivity of CEPA's approach to a small number of highly contested inputs remain unchanged** – The updated report undertakes a sensitivity assessment across some of its assumptions, but in substance maintains the 'base case' assumptions, such as the valuation of DFN revenues, capex levels and the terminal RAB value. These core assumptions continue to drive unrealistic outputs, and substitution of single inputs for alternative plausible values continues to result in multiples of close to one.

Critically, for the AER's considerations for the final Rate of Return Instrument, the new CEPA report adopts an entirely different analytical approach which does not result in a reporting of a fully disaggregated RAB multiple comparable to that produced in the original May analysis. This fully disaggregated RAB multiple, using robust parameters, is the key output which was sought by the Independent Panel and AER.

Rather, CEPA's main focus has been to derive a new estimate of a separate concept of 'excess equity returns'. Adoption of a different analytical methodology to seek to better understand an issue is a valid approach. To provide any new information or a cross-check on previous results, however, the different methodology must itself be robust.

In this regard we note that when applied using plausible input assumptions the new analytical approach adopted by CEPA in its updated report produces return on equity estimates below the CEPA's cost of debt estimate, and at values not supported by any other information (e.g. a real required return on equity of 0.5 per cent). This suggests that the new methodology is not robust and does not provide a sound basis for AER decision-making.

The attached Frontier Economics analysis using CEPA's published models and assumptions details these issues further (See Attachment A).

It shows that adopting the more appropriate mid-point estimate of AST's unregulated business from the relevant independent report - and applying the same CEPA estimates of other components impacting enterprise value - continues to result in a RAB multiple estimate of 1.06.

Implications for Assessment of Evidence in Review Context

A significant concern for energy network businesses through the review process has been the balanced consideration of evidence and ensuring a robust engagement with the substance of evidence put forward by all review participants.

In our view, the updated CEPA analysis does not satisfactorily or materially engage with the substantive questions raised over its methodology, sensitivity to uncertainties over key inputs, and its reported outcomes.

ENA remains concerned about the risks of the review not appropriately accessing and acting upon the best information possible to derive the unbiased rate of return estimate sought by the AER. CEPA's work was subject to significant critical focus, as it adopted a range of contentious assumptions that differed materially from independent expert practice to derive conclusions which professional valuation advisory firms indicated were unable to be supported by the analysis present.

Despite these concerns, the base case in CEPA's updated report has simply maintained critical input assumptions driving its original analysis, while making a range of small adjustments to other inputs, and focused on development of a different analytical frame of seeking to quantify and highlight 'excess equity returns'. Unsurprisingly, the result of using largely unchanged base case inputs is similar out-turn multiple estimates.

Through the review process, ENA has advanced and advocated a range of approaches and positions which the AER and its expert advisers have not agreed should be pursued. Where this has occurred, future representations have noted the preferred positions, but engaged with the evidence and options outlined by the AER as its current focus. Examples of this include recognition of the Wright model, development of a calibrated Dividend Growth Model, and questions raised in 2021 around the definition of the risk-free rate given some recent changes in UK regulatory practice.

By contrast, ENA is concerned for the perception to arise that, when key questions are raised about approaches or assumptions underpinning AER expert work, a primary focus may be to refute the basis of the questioning, rather than a balanced consideration of whether valid concerns have arisen.

For a process to be perceived as robust and independent, it is not sufficient for valid evidence advanced to be 'rebutted', often by the same parties offering the original advice. Such an approach risks a perception of technical experts 'doubling down' on established positions, rather than of fostering and encouraging an inquiring and evaluative process to best inform independent regulatory judgement.

There have been significant positive elements in the AER review process. Ensuring evidence from stakeholders is weighed in a positive, evaluative framework will promote high-quality evidence being provided to the AER on the difficult issues it must make balanced judgements around. In turn, this will maximise the opportunity for a Final Rate of Return Instrument which is best capable of promoting the long-term interests of consumers.

We are comfortable with this letter and the attached report to be published in full, noting they contain no confidential information.

If you wish to discuss any of the matters raised in this letter further, please contact Garth Crawford, General Manager, Economic Regulation, on [redacted]

Yours sincerely,

[redacted]

Andrew Dillon
Chief Executive Officer