27 May 2022

Ms Clare Savage
Chair,
Australian Energy Regulator

Sent via email

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

Dear Ms Savage,

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.

Last week, as part of this process, the AER released a commissioned report by Cambridge Economic Policy Associates (CEPA) on the issue of RAB multiples. This report 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. It also considered inferences that might be drawn from these estimates for ongoing AER work on the RORI.

Frontier Economics has reviewed the CEPA report and Grant Thornton have also have an opportunity for initial consideration of the CEPA analysis. These initial considerations by ENA's expert advisers have highlighted several fundamental issues affecting the analysis contained in the CEPA work. A copy of a Frontier Economics analysis of these substantive defects in the estimation of the relevant RAB multiples is enclosed (Attachment A).

While the AER has indicated that it will accept submissions on the report following the release of the Draft Instrument, ENA considers the analytical defects highlighted in the attached memorandum are highly material and lead to erroneous and misleading conclusions. This is materially relevant to the preparation of the Draft Instrument. In our view, these defects should result in no weight being placed on the findings of the report by the AER, the Independent Panel or other stakeholders.

The most significant concerns with the published CEPA analysis are that the report and analysis:

a. **Adopt a range of invalid or unrealistic assumptions which drive a significant mis-estimation of the resulting multiple outcomes** – As an example, CEPA values the unregulated Development and Future Network (DFN) business owned by

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AusNet at 1 to 3 times historical revenue resulting in a mid-point value of $370 million, where the mid-point estimate used in the independent expert report prepared by the valuation firm Grant Samuel is $3,150 million, or more than eight times higher.

b. **Fails to meaningfully assess the sensitivity of the conclusions of the report to adopted assumptions** – While the impact of incentive scheme performance, gearing and other assumptions are assessed, a demonstration of the sensitivity of key conclusions of the report to a set of plausible alternative assumptions on a number of other critical and unevidenced assumptions is not provided. Stakeholders are left with the impression that adjusted RAB multiples greatly exceed 1, whereas under a set of plausible assumptions the adjusted RAB multiple is close to, or below, 1.

c. **Fails to engage with relevant expert evidence provided to the AER in the RORI process in March** – The CEPA report, dated 10 May, fails to refer to, or engage with, the detailed expert report from accounting firm Grant Thornton on RAB multiple estimation issues, including consideration of disaggregation issues central to the CEPA report analysis. This report was submitted to the AER on 11 March, two months prior to the finalisation of the CEPA report.

d. **Fails to consider directly relevant evidence** – The CEPA analysis fails to discuss or take into account the direct evidence provided in the AST and SKI independent expert reports of estimated required returns on equity. Each of these estimates are well above current AER estimates of allowed returns on equity, and are directly relevant to the AER's estimation task.

The attached Frontier Economics analysis demonstrates that using CEPA's published models and assumptions, while adopting the more appropriate mid-point estimate of AST's unregulated business from the relevant independent report, results in a corrected starting point RAB multiple of 1.41.

Applying the same CEPA estimates of other components impacting enterprise value results in a RAB multiple estimate of 1.06. Two further adjustments recommended by Frontier– relating to the terminal RAB multiple assumed and expected RAB growth – results in a RAB multiple of 0.87. This is consistent with the AER's current allowed return on equity being *less* than the return required by market investors.

The same approach to estimating the value of unregulated earnings at a multiple of 1-3 times historical revenue has been applied by CEPA in relation to SKI, resulting in the same issue arising for this multiple estimate. Further, and significantly, the report appears to contain fundamental errors, mis-specifying in its analysis and presentation the enterprise value of all businesses, instead of Spark's proportionate ownership.

The CEPA report clearly indicates that it has adopted an assumption of no new investment in regulated assets beyond the current regulatory period, for the purpose of its analysis.

ENA finds this assumption an extraordinary analytical starting point given the energy transition underway and expected. It appears fundamentally inconsistent with a key focus of the 2022 review being to ensure adequate long-term investment incentives to promote efficient levels of new investment. As an example, CEPA's base case results in the assumed real value of AusNet's distribution business falling from over $5 billion to less than $220 million in 54 years – with no discussion of the plausibility of this assumption. This assumption is material to CEPA's conclusions.

ENA has highlighted in previous submissions, and it is a finding of the submitted Grant Thornton expert report, that reliable disaggregation of a RAB multiple from public data is an impossible task. The CEPA report demonstrates this and ignores published independent expert reports which provide a basis for transparently assessing the many critical assumptions flowing into a disaggregation analysis. Moreover, the report does not present the sensitivity of its overarching analysis to key assumptions made, potentially leading stakeholders to an erroneous conclusion about the robustness of the findings of the report.

While ultimately matters for the AER to reach a determination upon, ENA considers that the most appropriate course of action given the issues discussed would be for the AER to:

- Withdraw the analysis from any AER and Independent Panel consideration in its entirety; and
- Adopt the AER's past stance of giving RAB multiples no role in the estimation or cross-checking of regulatory rates of return in the Draft and Final Instrument.

Certainly, in ENA's view, it would not be appropriate for the Independent Panel to be provided with the CEPA analysis without also being provided and directed to this correspondence and the attached memorandum which point to significant errors in the analysis.

Adopting the course of action recommended above would help provide stakeholders with clarity and confidence that evidence before the AER is sufficiently robust to maximise the opportunity for a Draft and Final Rate of Return Instrument which is 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 it contains 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
CEO