Rate of Return Guideline Review

AER Board Meeting Discussion

17 May 2018

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Overview

- » Have advocated an objective of setting a guideline that is ‘capable of being accepted’ and applied by stakeholders. To support this we have:
  - – Sought to effectively engage with stakeholders to provide input throughout the review and will continue to do so
  - – Taken feedback into account in our submissions and suggestions and advised where we have done so
  - – Been objective in assessing evidence and taken a balanced approach
- » Networks have supported the AER position of undertaking an incremental review:
  - – taken a deliberate action of not re-agitating areas already decided (such as the foundation model approach)
- » Overall, our view is that there has been:
  - – no change in finance theory and/or new evidence that warrants a change in approach
  - – update of evidence does not suggest a material change in overall rate of return
  - – no other (indirect) evidence suggesting current returns are too high

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Engagement with customer groups

» Networks have sought to ‘lean in’ to their customer and other stakeholder engagement commitments

» ENA-AER Consumer Reference Group Dialogue process

– agreed position on averaging period for cost of equity

– common guidance provided to AER on role of transparency and judgement on evidence

– development of joint project on past expenditure, RAB drivers, and rate of return issues: expected to be in position to submit to draft guideline in August

– collaborative advice through to AER on areas of focus in expert sessions

» Potential opportunities to progress ENA-CRG process beyond draft guideline: further potential work has been identified

» ENA members have also been engaging with ‘business as usual’ customer representatives to feed into responses

Comparison of allowed equity risk premium across jurisdictions

	Allowed equity risk premium	Source
AER	4.55%	AER decisions
Commerce Commission (New Zealand)	5.51%	Cost of capital determination for disclosure year 2019 (Electricity distribution businesses and Wellington International Airport), April 2018
Ofgem (Great Britain)	5.83%	RIIO-2 Framework Consultation document, March 2018, Table 4; accompanying CEPA papers
Federal Energy Regulatory Commission (United States)	8.07%	Emera Maine v. Federal Energy Regulatory Commission, Case No. 15-1118, 14 April 2017; US government bond yield data obtained from the US Department of the Treasury

Notes: Equity beta used to calculate equity risk premiums allowed by Ofgem and New Zealand Commerce Commission have been re-levered using gearing of 60% to allow comparability; The real allowed return set by Ofgem was converted into nominal rates using an expected inflation rate of 3.2% recommended by Ofgem's advisers, CEPA; the equity risk premium allowed by FERC was calculated by subtracting from the prevailing return on equity allowance permitted by FERC the average nominal yield on 30-year US Treasury bonds (since FERC's practice is to use a 30-year term for the risk-free rate) over April 2018; the FERC return on equity decision is currently under review following an successful appeal (April 2017) by regulated businesses that overturned FERC's decision to lower the allowed return on equity from 11.14% to 10.57%.

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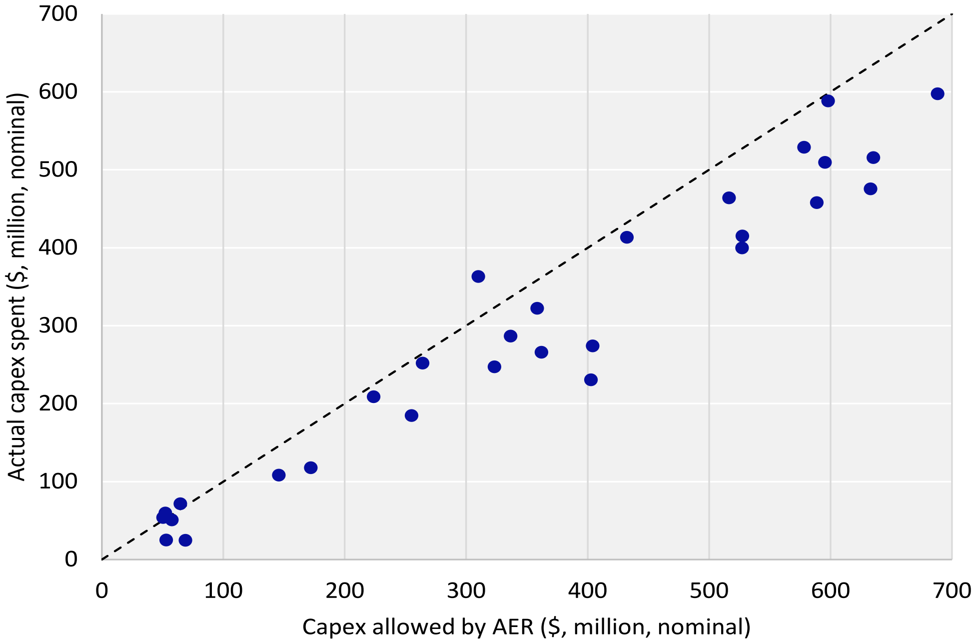
Context of 2018 guideline

Allowed equity returns materially reduced in 2013, and further declines have followed…

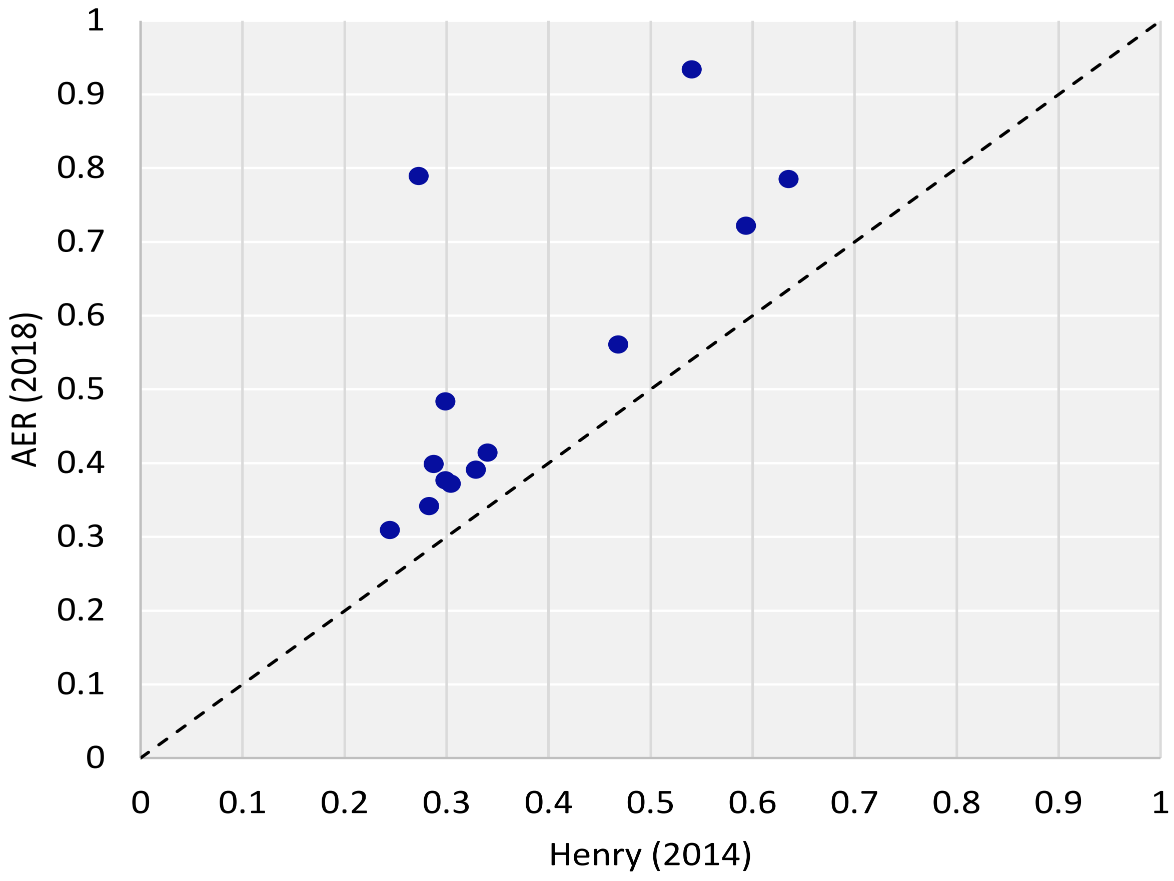
Capital investment evidence not consistent with rates of return driving excess investment



Equity beta

- Analysis indicates upward movement in equity beta – using past AER approaches
- Smaller number of comparators available since 2013
- **Equity beta estimate evidence is not uncertain or mixed – all estimates have increased**
- Only change that could be made to the equity beta allowance is an increase.

Movement in equity beta estimates since 2014



Market risk premium

- Empirical evidence suggests that the MRP has increased since 2013
- **No Australian regulator that sets a current, forward-looking MRP allowance has, within the past year, set an allowance lower than 7.0%.**
- The Dividend Growth Model (DGM) provides useful evidence on the current MRP and should be given explicit and material weight by the AER.
- There is no evidence to support a weakening of the role of the DGM since the 2013 Guideline.
- Should the AER choose to re-open the MRP, updated evidence clearly suggests some increase would be required

Change in AER's MRP estimates since 2013 Guideline

Estimation method	AER 2013 Guideline estimate (%)	Estimate in AER'S November 2017 Decisions (%)
Historical excess returns	Point estimate: 6.0	5.1 to 6.4[1]
Dividend growth model	6.1 to 7.5[1]	6.24 to 8.7[1]
Surveys	Supportive of 6.0	7.3 to 7.6[2]
Conditioning variables	Qualitative consideration	Qualitative consideration
Regulatory determinations	Supportive of 6.5	7.2 to 7.7[3]
Wright approach (used by AER as "cross-check")	5.8 to 8.7	7.2 to 9.8[4]

Source: AER 2013 Rate of Return Guideline Materials, AER APA Final Decision
Notes: [1] Full range reported in AER decision; [2] Obtained from 2017 survey by Fernandez et al.; [3] Reflects regulatory decisions over the 12 months to November 2017; [4] Total Wright CAPM and risk-free rate estimates obtained from AER decision, assumes equity beta of 0.7 per point estimate in AER decisions.

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Gamma

- **The best available estimate of the company tax paid by the average firm that is returned to its investors through the utilisation of imputation credits is the ATO estimate of 0.34**.
- ENA considers the reliability of that direct estimate to be materially higher than alternative upper bound estimates compiled as the product of a distribution rate and equity ownership proportion.
- The Lally ‘20-firms approach’ to estimating distribution rates is not appropriate because:
  - the firms in question are not representative of either of the relevant characteristics of the BEE
    - They are not highly-levered, capital intensive firms providing access to infrastructure assets operating wholly within Australia.
  - the approach is affected by the general problem of the difficulty of estimating the distribution rate for an individual firm
  - a number of issues and inconsistencies relating to the Lally estimates have been identified and are not yet resolved.

Cost of debt

» **Trailing average cost of debt approach should be 'locked in' as part of an incremental review: broad support from stakeholders**

» 10 May – Release of AER Cost of Debt Discussion Paper: industry still analysing the contents

» ENA members and experts have reached out to AER/Chairmont to better understand data issues and ensure we can understand what has been done in a few areas

  – Equal weight given to all debt issues. This overweights short term debt which, by definition, is issued more frequently. Gives 10 times weight to $1m of 1 year vs $1m of 10 year debt

» Have advocated an incremental approach on alternative debt series, including reviewing any proposed new source for transparency and reliability over time

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What are we asking for

» 'Capable of acceptance' draft guideline which:
  – deliver outcomes that are in the long-term interests of consumers
  – including by ensuring network businesses are able to achieve a reasonable and commercially sustainable return on investment
» Networks see absolutely no evidence for any downward movement in the cost of equity parameters or approach
» Continuance of cost of debt trailing average will deliver greater stability in future prices for customers