AER Rate of Return Guideline Review

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AER Consumer Reference Group Meeting, 23 January 2018

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Objectives

- » Primary process goal of a guideline that is **‘capable of acceptance’** by all stakeholders
- » Overall goal of guideline that achieves the National Electricity and Gas Objectives and the Allowed Rate of Return Objective
  - – clear and agreed focus of membership is on a reasonable, balanced long-term outcome that is capable of acceptance by all stakeholders
  - – not on abstract maximisation of a ‘final number’
- » Keen to explore opportunities for direct engagement and new forms of collaboration with consumer representatives in guideline process

Background – current overall approach

- » Building constructively and incrementally on 2013 review outcomes
  - – Network businesses will **not** be advocating the 'multi-model' approach businesses previously proposed
  - – Agree that there are **no major developments** in finance theory that would warrant a new approach
  - – Support the **updating of key empirical data** and the application of the **AER's foundation model approach**
  - – **No material issues in debt**
  - – Comments on gamma focused on **data and implementation of AER approach**
- » Risk assumptions and outcomes consistent across the regulatory framework

➔ **"Capable of acceptance" goal**

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Where are we broadly?

Issue	Status	Potentially able to be settled?
Cost of debt	Transitioning to AER-approved trailing average approach	✓
Gamma	Acceptance of appeal outcomes, focus on implementation and refinement of ATO data supporting AER approach	✓
Term of risk-free rate and averaging period	Shared concern on unstable/lottery type outcomes for customers	✓
Gearing	Application of settled AER approach to updated data	✓
Cost of equity	Broad agreement to apply incremental approach to past AER approach to reach more stable allowances/prices that are capable of acceptance	Yes – key future opportunity to be taken?

Possible approach on collaborative next steps

» The following proposed approach is put forward for discussion, feedback and CRG perspectives

» Propose progressively scheduling initial smaller group network-CRG ‘exploratory’ meetings around some defined topics:

1. Initial meeting - Explore an agreed set of specific ‘low hanging fruit’ guideline issues on which relatively rapid agreement or consensus may potentially be reached
2. Follow on meetings – Use momentum to address other issues, e.g.
   - » Share perspectives on possible approaches on agreed **higher priority issues** (such as cost of equity)
   - » Agree useful focus and **topics of concurrent expert sessions**
   - » Discuss proposed terms of reference for any AER or joint work on high priority issues

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Possible approach on collaborative next steps (II)

» For example, ‘low hanging fruit’ discussions could potentially focus on

1. Benchmark approach to setting risk-free rate
2. Averaging periods for risk free rate and avoiding unnecessary volatility
3. Trailing average cost of debt
4. Approach to benchmark gearing assumptions and evidence

» **Goal for initial meeting** - gauge extent to which networks-CRG could reach common ground on broad outcomes relatively quickly, to:

– enable focusing of limited resources on the key outstanding issues; and

– help build collaborative momentum on wider set of issues

» Potential future opportunities for collaboration around other issues

– e.g. role of profitability data and available RAB multiples in future rate of return estimation processes

Network returns have been substantially reduced over the last five years

- Figure 1 shows that the regulated rate of return to nearly all electricity networks has fallen significantly between 2011-12 and 2016-17.
- Figure 2 shows that there has been a steady downward trend in the average allowed rate of return across all regulated business, over the past 5 years, with a large step-change reduction in 2015-16 when the AER last reset revenue allowances for most networks.
- The average allowed rate of return has fallen from 9.6% p.a. in 2011-12 to 6.7% p.a. in 2016-17 (a reduction of nearly 30%).
- Current market-based evidence on cost of equity suggests this 30% reduction may be in a process of partial reversal

Figure 1: Rate of return allowance to individual regulated networks (% p.a.)

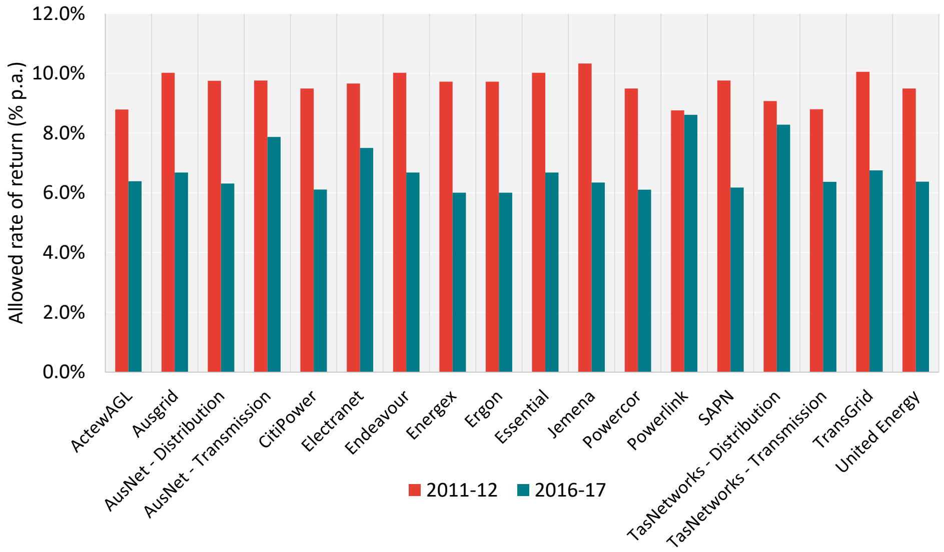
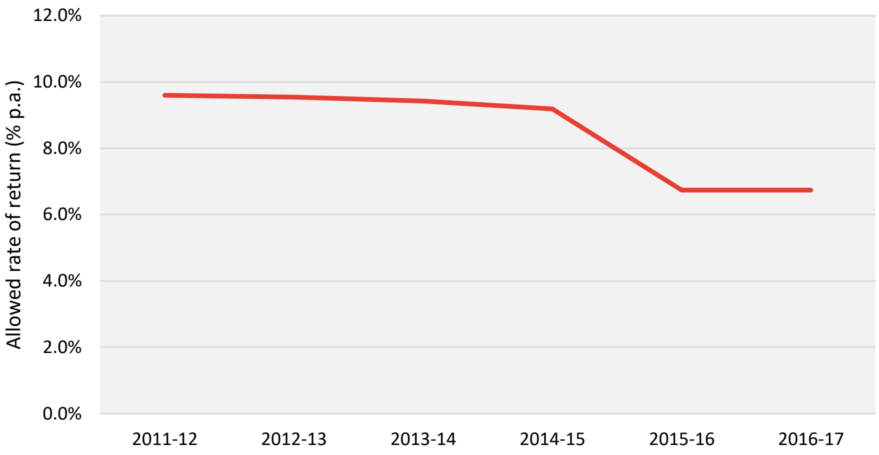


Figure 2: Average rate of return allowance (% p.a.) across networks



Return on capital now represents a materially smaller share of regulated networks' annual revenue allowances

- Figure 3 shows that the contribution of the return on capital allowance to total revenues has fallen for electricity networks between 2011-12 and 2016-17.
- Figure 4 shows that the average contribution of the return on capital allowance to total allowed revenues, across all regulated electricity networks, fell from 53% in 2011-12 to 47% (a reduction of nearly 11%).

Figure 3: Return on capital as a share of maximum allowed revenue

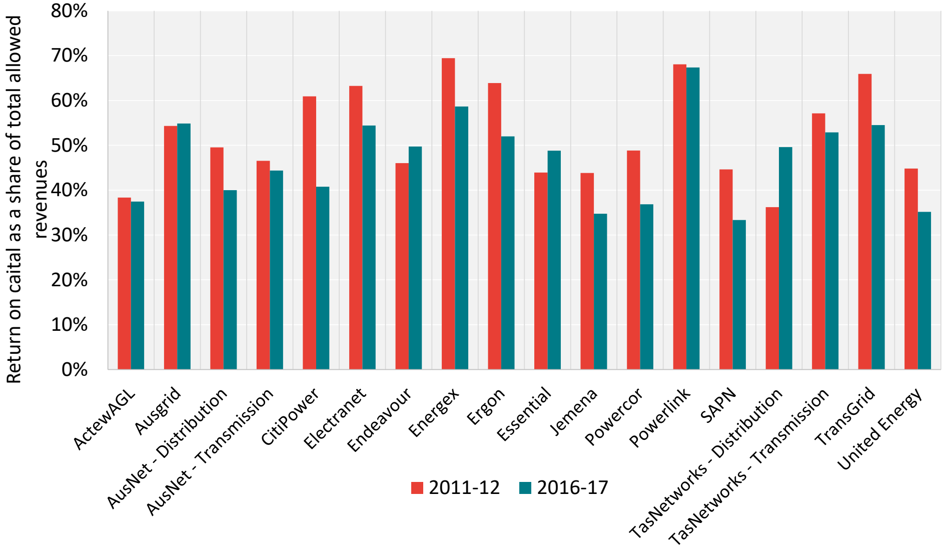
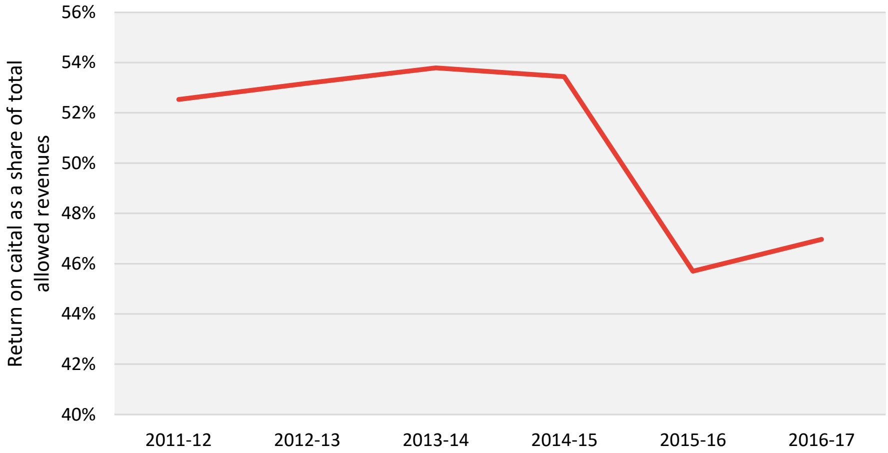


Figure 4: Average ratio of return on capital to maximum allowed revenues across networks



Change in regulatory allowances 13/14 to 16/17

Network	Change in $ allowance for return on capital	Change in $ allowance for return on capital per dollar of RAB
Ausgrid	-20%	-29%
Endeavour	-16%	-28%
Essential	-17%	-29%
ActewAGL	-30%	-38%
Ergon	-35%	-43%
Energex	-36%	-43%
SAPN	-26%	-36%
TasNetworks - Distribution	12%	4%
TransGrid	-30%	-39%
Powerlink	18%	0%
AusNet - Transmission	-3%	-20%
Electranet	21%	0%
TasNetworks - Transmission	-23%	-31%
CitiPower	-28%	-39%
Powercor	-20%	-36%
United Energy	-15%	-31%
AusNet - Distribution	-15%	-34%
Jemena	-18%	-34%
RAB weighted average	**-18%**	**-30%**

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Thank you

Key contacts through guideline process:

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Appendix - Initial ENA suggestions for concurrent session topics

Topic Area - Overall allowed rate of return

- Where does the balance between judgement and data lie, and how precisely can we seek to estimate rate of return parameters objectively, and in a way that can be replicated independently by any stakeholder, using market data?
- Under what circumstances should a binding Rate of Return Guideline be re-opened?
- How should the changing risk profile faced by networks be taken into account in the regulatory framework?

Topic Area - Market risk premium

- What role should the geometric mean of historical excess returns play in arriving at an estimate of the MRP?
- What role should DGM estimates play in arriving at an estimate of the MRP?
- How should the Wright evidence be used to inform the estimate of the MRP? How is this evidence used by other regulators?
- How should independent expert valuation reports be used to inform the estimate of the MRP?
- What estimate of MRP is supported by recent decisions of other Australian regulators?
- What estimate of MRP is supported by recent surveys?
- How should the set of relevant evidence be distilled into a single MRP point estimate?

Appendix - Initial ENA suggestions for concurrent session topics

Topic Area - Equity beta

- Can a reliable estimate of equity beta, or a reliable range, be obtained from the three remaining firms? If not, how can the reliability of equity beta estimates used by the AER be improved?
- Should equity beta estimates be re-levered to the 60% gearing of the BEE?
- What is the appropriate role for the evidence on equity betas of overseas energy network businesses?
- What is the appropriate role for the evidence from domestic infrastructure businesses?
- How should low-beta bias associated with the SL-CAPM, and evidence from the Black CAPM, be taken into account when implementing the foundation model approach?

Topic Area - Estimating value of imputation tax credits

- What are the relative merits of the ATO tax statistics and equity ownership approaches to estimating gamma under a utilisation rate interpretation?
- What are the relative merits of the ATO tax statistics and the “Lally” approach to estimating the distribution rate?
- What role should data that is 12 or more years out of date have when estimating gamma using the equity ownership approach?

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