AUSTRALIAN ENERGY REGULATOR

RAB MULTIPLES

Explanatory Note

This note explains our approach to report on RAB multiples for the network service providers (NSP or NSPs) we regulate as well as factors that should be taken into consideration when interpreting these ratios. This note discusses:

- *Calculation and scope of RAB multiples*
- *Approaches to report RAB multiples*
- *Notes on interpreting RAB multiples*
- *Factors which influence RAB multiples*

Calculation and scope of RAB multiples

RAB multiples are calculated using the following formula:

$$\text{RAB Multiple} = \frac{\text{Enterprise Value of NSP}}{\text{Regulatory Asset Base}}$$

In simple terms, RAB multiples can be thought of as an indicator of investor expectations about the sufficiency of cash flows from investment in a NSP.

As a market-based metric of investor expectations, RAB multiples are distinct from all other profitability measures which are financial-based metrics.

For a detailed background on the theory of RAB multiples, we recommend reading Dr Darryl Biggar's paper 'Understanding the role of RAB multiples in the regulatory process'.[1] As set out in in Dr Biggar's paper:[2]

> *One of the common objectives in public utility regulation is to ensure that the investors in the regulated firm are adequately compensated – and no more than adequately compensated – for the funds they provide to the regulated firm.*
>
> *RAB multiples are an objective, market-based, measure of the present value of the expected future cash-flows of the firm relative to the amount required to fully compensate investors in the firm.*
>
> *They therefore are sometimes taken as a measure of whether the regulatory framework is achieving this objective.*

Approaches to report RAB multiples

We will report two types of RAB multiples:

- Transaction RAB multiples
- Trading RAB multiples

Transaction RAB Multiples
Multiples arising when an asset or part of an asset is sold.
Implications:
Generally relate to a specific regulated asset. In this way they are more likely to have direct implications for regulated cash-flows.
However, they may also be affected by specific issues relating to acquisition of a controlling stake in an asset such as a 'control premium'. Similarly, they may be affected by 'winner's curse'. Both of these factors are discussed in Dr Biggar's paper.
Trading RAB Multiples
Multiples generated for listed entities using the market capitalisation of the company.
Market capitalisation is the total market value of a company's shares, or number of shares multiplied by price per share.
Implications:
Relate to publicly listed entities that own regulated assets. These multiples reflect the share price of publicly traded entities, which involve the trade of smaller proportions of equity than a full acquisition, they are less likely to include a control premium or winner's curse.
However, these listed entities may also own unregulated assets or provide unregulated services which may affect the RAB multiple without being informative about the regulatory framework.

We will source our RAB multiples for reporting from credible market experts and publish them with permission.

Where we are aware of materially different estimates for the same RAB multiple, we will seek to publish both multiples.

Further, where we identify relevant comparator multiples as reference points for our published multiples, we will include them in our reporting.

[1] Available here.

[2] Biggar D, *Understanding the role of RAB multiples in regulatory processes*, ACCC Regulatory Economic Unit, February 2018, p. 1.

Notes on interpreting RAB multiples

An assessment of RAB multiples is subject to the factors provided below. However as a simplistic view:

- RAB multiples equal to one implies that the present value of expected returns from an asset is precisely equal to the value of the asset base.
  In principle, this means that investors in that asset receive exactly the returns they require to encourage efficient investment.
- RAB multiples above one may suggest that investors expect network regulation to allow excess returns.
- RAB multiples below one may suggest that investors expect network regulation to allow insufficient returns.

However our regulatory framework is designed to encourage long-term efficiency through incentives under which NSPs are able to outperform the regulatory allowance and keep some of the short-term benefits of this outperformance while the long-term benefits should flow to customers. As described in Dr Biggar's paper:[3]

> *As we will see, RAB multiples are affected by a range of factors.*
>
> *A RAB multiple may be well above one, even though the regulatory cost of capital is equal to the firm's true cost of capital, and even without any other systematic failures or defects in the regulatory framework.*
>
> *A high RAB multiple is not immediately cause for concern.*

However conversely Dr Biggar's paper noted:[4]

> *It is worth emphasising that a RAB multiple close to one does not indicate that the regulatory regime as a whole is achieving its objectives.*
>
> *The objective that "investors in the regulated firm expect to receive a normal return on their investments" is only one of many possible objectives for a regulatory framework.*
>
> *Other possible objectives include the objective that the regulated firm be operated efficiently, that the regulated firm deliver the quantity and quality of services that customers' desire, and that customers receive value for money.*
>
> *These other objectives are independent of the level of the RAB multiple.*
>
> *A RAB multiple close to one only indicates that the investors in the firm expect to be adequately compensated for the expenditures which they incur.*
>
> *If those expenditures are inefficient, or if the firm delivers poor quality of service, customers may still receive low value for money.*
>
> *In summary, even if the RAB multiple is close to one, the regulatory regime could be failing in other ways.*

Factors which influence RAB multiples

Importantly, there are a range of factors, in addition to expected returns, that can influence RAB multiples. A RAB multiple greater than one may be the result of a buyer:

- Expecting to achieve greater efficiency gains that result in actual operational and capital expenditure below the amount currently allowed by the regulator
- Expecting to increase the NSP's revenue by increasing demand for regulated services
- Benefiting from a more efficient tax structure or high gearing levels than the benchmark assumption adopted by the regulator; and
- Expecting to achieve higher returns if regulation is relaxed.[5]

It is also possible that a high RAB multiple arising from the sale of an asset is a reflection of other factors, including:

- The 'winner's curse', with the winning party in an auction or tender process likely to have over-paid as a result of the competitive nature of the acquisition process.[6]
- Expected returns from unregulated business units within the transacted asset (transaction multiples) or the listed entity (trading multiples).

The factors described are not easily quantified. However, RAB multiples persistently higher or lower than one may serve as a trigger for further investigation.

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3 Biggar D, *Understanding the role of RAB multiples in regulatory processes*, ACCC Regulatory Economic Unit, February 2018, p. 1.

4 Biggar D, *Understanding the role of RAB multiples in regulatory processes*, ACCC Regulatory Economic Unit, February 2018, p. 3.

5 AER, *Discussion Paper: Overall Performance Measures*, February 2018, p.13.

6 Biggar D, *Understanding the role of RAB multiples in regulatory processes*, ACCC Regulatory Economic Unit, February 2018, p.4.