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ENERGY
COUNCIL

DRAFT RATE OF RETURN GUIDELINE

MEETING WITH AER BOARD

October 2018

AER’S BALANCING ACT

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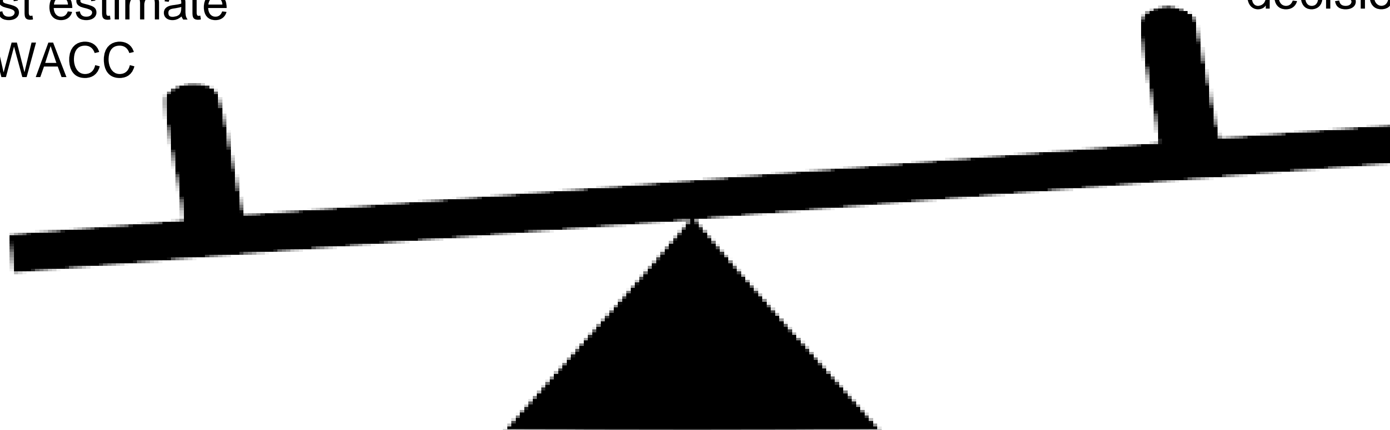
Consistency with previous decisions

Best estimate of WACC



DRAFT GUIDELINE

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- AER has arrived at a balanced decision
- Some parameters could have been set higher on the evidence, but others could have been set lower
- Process has been extensive and multi-faceted and represents a full and fair consultation process to date.
- Independent Panel's report is a constructive input to the process

FOCUS OF SUBMISSION

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Generic parameters	Sector-specific parameters
Risk-free rate	Gearing
Market Risk Premium	Equity Beta
Gamma	Return on debt

- AER approach to generic parameters well-established
- Our focus is on the sector-specific parameters

GEARING & CREDIT RATING

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- Is a 60% gearing correlated with a BBB+ credit rating (and thus the cost of debt)?

- Moody's methodology most transparent, but still entails judgment
- 10 weighted factors
- Mix of qualitative and quantitative factors
- Qualitative factors generally relate to regulatory framework and support a higher credit rating (A, A-)
- Based on draft guideline and typical ratios for an electricity distribution business, key financial ratios around BBB/BBB-
- Weighted result supports BBB+

EQUITY BETA

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- Regulated networks very low levels of systematic risk, due to nature of business and operation of framework:
  - Zero revenue risk (electricity networks)
  - CPI uplift to revenue guaranteed
  - Opex and capex incentives entail sharing of excess costs with customers
  - Passthrough and reopeners on specific items hard to forecast ex ante
  - Limited if any currency risk
  - Cost of debt methodology a buffer against interest rate risk

- Lower beta than 0.6 would affect key financial ratios

EQUITY REQUIREMENTS

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- Capex programmes have moderated from early years of national framework
- Virtual PTRM exercise (also used for key financial ratios) consistent with equity raising only through DRP
- Actual equity raising by listed entities (aside from for acquisitions) around once in a five year period
- Still require an adequate cost of equity, but given uncertainties involved in estimate this means lower impact of downside risk
- If there are exceptions, eg some transmission businesses if ISP is implemented, should not impact cost of capital for all businesses

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