AER Rate of Return Public Workshop: Discussion summary

Matter name:	Australian Energy Regulator (AER) Rate of Return Public Workshop		
Date:	Monday 18th September 2017		
Time:	9:00am to 1:00pm		
Location:	Stamford Plaza Sydney Airport 24 1 O'Riordan St, Mascot NSW 2020		
Phone to ☐	**Phone from** ☐	**Meeting** ☒	**Other** ☐

Note: This document provides an overview of the main points discussed during the AER Rate of Return Public Workshop. Its use is purely informative. Stakeholders may find the information in this document of assistance to them in making submissions on the AER's issues paper, due October 2017.

The Australian Energy Regulator (AER) held a public workshop to discuss the upcoming Rate of Return Guideline, due at the end of 2018. The workshop gave AER staff an opportunity to test initial thinking with stakeholders, and the opportunity for stakeholders to influence the topics addressed in the AER's forthcoming issues paper.

The session included a series of presentations from AER staff, network representatives, consumer groups, and investors. Outside of the presentations, AER staff provided topics for guided discussion which took place between groups of stakeholders. All discussion groups provided feedback at the end of the session, allowing everyone at the workshop to hear a range of views and opinions on the discussion points from different perspectives.

The following is a summary of key themes from the day.

Initial Discussion – Guideline Acceptability

The first session of the workshop was focused on the process for review of the guideline. In particular, AER staff raised a possible objective for the consultation process based on submissions made by stakeholders. Specifically, this was that the consultation process should allow us to develop a guideline capable of being accepted and applied by all stakeholders. Following the presentation, AER staff proposed two questions for groups to discuss on this topic:

- Is it useful for the AER to have such an objective for this process?
- Is the proposed process sufficient to reach this objective?

On the first point, groups came to a conclusion that the objective is a good one for the AER to have as it promotes the work and collaboration that is likely to foster a positive result for everyone if implemented from the start. Some groups recommended additional detail to make the objective more readily measurable. Both consumer and network representatives agreed that promoting open discussion in order to reach a guideline that worked for everyone was in their interest, as opposed to the push and pull dynamic that had occurred in many determinations in recent years.

Some groups highlighted that while the proposed objective was useful in terms of process, it was important for the focus of the review to be on determining a rate of return that satisfied the National Electricity and Gas Objectives. Ultimately, the guideline should a deliver a rate of return that reflects the risks involved in providing regulated services recognizing the uncertainty involved.

Stakeholders emphasized that in order to promote the proposed objective, it was necessary for all work on developing the guideline to be transparent and consistent. This includes clear communication in order to make sure that stakeholders understand the AER's positions and methodologies and the evidence underlying them.

In regards to the second point, stakeholders were optimistic that the process could contribute to a guideline that all stakeholders could accept, but highlighted that there was also potential for it not to succeed. Stakeholders highlighted the importance of the independent panel review. Stakeholders also highlighted that acceptance of the process would depend on confidence that the AER had maintained an open mind and not pre-determined the outcomes of the review.

On the specific steps proposed by the AER in its consultation paper:

- Some stakeholders suggested that the independent panel review of the draft guideline should review the outcome of the guideline rather than being restricted to reviewing the process

- Stakeholders reiterated that the consumer reference group will need strong support from the AER to add value to the process

- Stakeholders raised issues and questions about how the concurrent evidence (hot-tub) process would run and who would be considered experts for the purposes of that process.

Main Discussion – Guideline Priorities

The next session involved presentations from the AER, consumer groups, network representatives and investor groups, in which presenters put forward their opinions on issues with the current guideline and how these could be addressed in the future.[1] This was followed by a further discussion session. Similar to the last session, the AER posed questions for discussion:

- Should the AER build on the knowledge base gained from development and application of the current guideline or start from a blank slate?

- What are the high, medium and low priority issues for the guideline review?

- Should the AER prepare a prescriptive guideline to enable the mechanistic estimation of the rate of return through a formula?

The role of the current guideline

[1] The slides from these presentations can be found on the AER's website at: http://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-rate-of-return-guideline

On the first point most participants agreed that the AER would be unwise to start from a blank slate. Given the knowledge, evidence and expertise it has built up over the years there would be a lot lost if a blank slate approach was taken. Despite the agreement on this approach, several discussion groups noted that the knowledge gained to date on the AER's approach should be open to question. Where knowledge is kept and built upon, it should also be scrutinized to get the most out of the guideline review process.

While consumer groups also generally supported the idea of building from the current guideline, some highlighted that the AER should look at evidence including RAB multiples and actual profitability to assess how well the current guideline has performed. In particular, consumers pointed towards high reported transaction multiples for recently privatized businesses as evidence that the AER's current guideline was producing estimates that are sufficient if not too high.

Prioritization of issues for the review

After the high-level discussion, the groups discussed an indicative prioritization of issues that AER staff presented on the day. This indicative summary covered topics such as the definition of the benchmark efficient entity, the data series used for estimating the return on debt and the relative weight afforded to material involving both the Market Risk Premium and the equity beta.

In discussing the indicative prioritization, there were several subjects that came up repeatedly, despite not being directly linked to any specific element of the guideline. Firstly, most stakeholders supported a clear categorization of issues into low, medium and high priority as part of the issues paper, noting that this does not prohibit other issues from being raised in submissions.

Most discussion groups agreed that in order for the guideline to be improved the AER must focus on transparency, certainty and replicability. Discussion groups gave examples such as equity beta, which hadn't changed in value since the 2013 rate of return guideline despite changes in inputs and other evidence. Because some stakeholders were unable to replicate these calculations it was hard for them to understand what evidence would justify a change to the value of equity beta.

While there was general support for elements of the AER's priority listing, several of the presentations and group discussions identified other elements of the guideline that stakeholders saw as high priorities:

- Estimation of equity beta—Some stakeholders indicated that there is a declining set of comparator companies available for estimation of equity beta which should warrant a more substantial review of estimation than just an empirical update. This would include consideration of the definition of the benchmark efficient entity.

- Conservatism in parameter estimates—Some stakeholders indicated that there is a understandable case for upward conservatism in setting individual elements of the rate of return methodology, but that the outcome of this interactive conservatism is a systematic upward bias.

- Reliance on the Sharpe-Lintner CAPM—Whilst AER staff view its usage to be fairly settled, some stakeholders indicated that more study should be done into its limitations and the way the AER implements the model.

- Interaction with the RAB—Some stakeholders recommended that the AER should consider the role of the RAB in the return on capital and whether the RAB is excessive.

- Averaging period for equity—to enable a more stable rate of return or to bring both return on debt and return on equity in line with each other.

- Interaction with the review of expected inflation—the approach to estimation of inflation, while not strictly a rate of return parameter, has implications for the risk borne by networks and consumers.

- Outcomes of the review— stakeholders requested that the guideline development process should set out indicative outcomes for different methodology or parameter choices so the materiality of those issues is clear.

Some discussion groups indicated that the ‘high priority’ items should be divided into separate categories. For example, those high priority items could be split or categorized again into those that could be easily addressed at the start of the process, such as the debt series choices, or those that need a large amount of work such as the level of prescription involved in the guideline. There was also a suggestion that analysis would be facilitated by employing common datasets that had been agreed between participants.

Finally, when considering how best to implement the prioritization process, some stakeholders reiterated that areas where there is agreement should be specified in considerable detail. This will be important in assisting stakeholders to follow the guideline process, to recognize innovations and to avoid misunderstanding. Precision in the establishment of methodologies or values will be critical to the implementation of a prescriptive binding instrument.

A prescriptive guideline capable of mechanical implementation

The final discussion question was in regard to preparing a mechanistic or explicitly prescriptive guideline. This discussion point was raised in the context of the COAG Energy Council’s agreement to implement a binding rate of return guideline.[2] Discussion groups considered the feasibility of a highly prescriptive guideline, the process which would allow it to be implemented and what checks such a guideline would need in the case of a significant change in market conditions.

In general, stakeholders agreed that it is practically achievable to have a mechanistic or highly prescriptive guideline. Nonetheless, some stakeholders suggested that a binding guideline should not be completely mechanistic. Some stakeholders recommended that the key goal for such a guideline should be a definitive method on all issues, with clear and replicable data and methods allowing everyone to follow the process and the outcomes. If that led to a guideline that can be implemented mechanistically then most discussion groups would be satisfied with this outcome.

Finally, when considering the implications of a prescriptive binding guideline, stakeholders indicated support for a ‘breaking point’ or escape route which would need to be built in. Some discussion groups felt that such a mechanism would need to be built in as a matter of course due to potential changes in the market conditions in the coming years. They highlighted the 2008 global financial crisis. Such an event would require evidence to be re-evaluated ahead of the schedule for review of the guideline. Any ‘breaking point’ mechanism would have to be well defined and replicable so that all stakeholders can monitor the possibility of a guideline review process being re-opened ahead of schedule and out of cycle.

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[2] COAG EC announced this in its July 2017 communique: http://www.coagenergycouncil.gov.au/sites/prod.energycouncil/files/publications/documents/12th%20COAG%20Energy%20Council%20Communique%20V2.pdf