Rate of Return Guideline

CCC/ Customer Forum Consultation Session

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Purpose and Agenda

Purpose: To seek views on the AER's Draft WACC Guideline and industry's views to inform our response

Agenda:

- **Background**
- **Process so far**
- **Consumer Commentary**
- **Draft Guideline – Cost of Equity**
- **Draft Guideline – Cost of Debt**
- **Draft Guideline – Value of Imputation Credits**

Background

- **The Rate of Return sets approximately 35% of AusNet Services' revenues (ED)**
- **The Guideline was last reviewed in 2013. Unlike the 2013 Guideline, the 2018 Guideline is expected to become binding on both the AER and businesses.**
  - Follows a series of appeals by networks and customer groups on the 2013 Guideline, which are not all yet resolved.
- **Industry would like a Guideline that is capable of being accepted by all stakeholders – customers, investors and networks.**
- **AER intended to undertake an 'incremental review' for the 2018 Guideline**
- **AusNet Services primarily engages in Rate of Return Reviews through Energy Networks Australia.**

Process so far

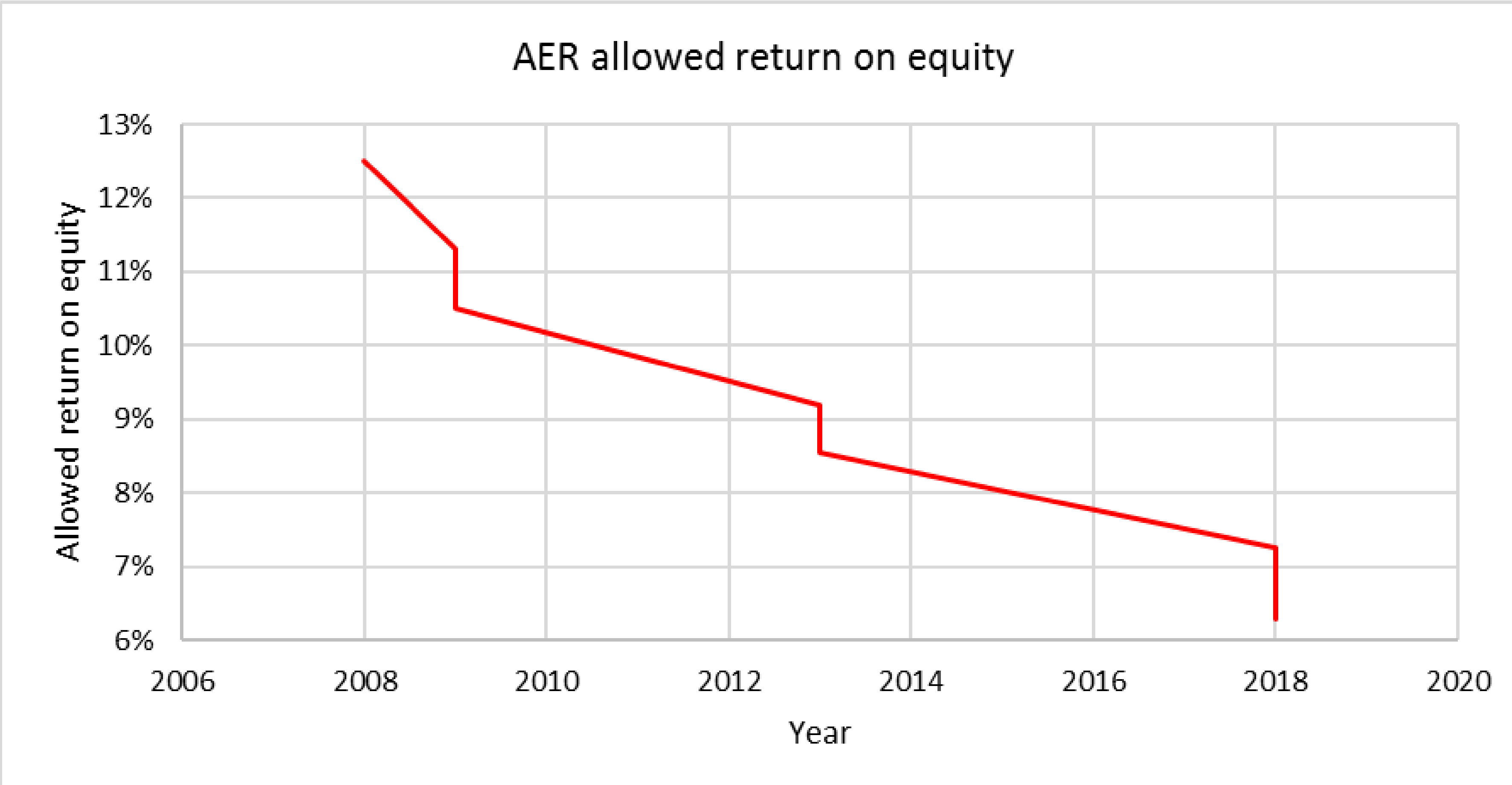
- **Commenced in July 2017**
  - Consultation on the process – written submissions and a public forum
- **Issues paper – October 2017**
- **Information and Discussion Papers – Feb – April 2018**
  - Equity beta, gearing, risk and judgement, financial performance, RAB multiples, gamma, Market Risk Premium
- **Two expert sessions – Feb and March 2018**
  - Expert joint report produced, submission lodged
- **Debt Issues Paper – May 2018**
  - Submissions lodged
- **Draft Guideline published – 10 July 2018**
  - Public forum in August, submissions due 14 September
- **Independent Review of Draft Guideline**
- **Final Guideline due December 2018 –** will apply to AST from 1 Jan 2021

Consumer commentary

Comments from different consumers and consumer representative groups in this process include:

- Even under an incremental review the starting points for the parameters (estimated in the 2013 Guidelines) need reconsideration.[30]
- The current rate of return is too high and has not achieved the NEO.[31]
- The AER was conservative (in favour of the service providers) in estimating all WACC input parameter values towards the top of empirical ranges (or in favour of service providers) in its 2013 Guidelines. In this review, the AER should set less conservative estimates.[32]
- Consumers themselves are facing large risks associated with increasing energy prices, particularly vulnerable consumers. This should be given consideration when the AER exercises judgment in the determining the rate of return and gamma. In light of these concerns, the AER should not be conservative in exercising its regulatory judgement in favour of service providers.[33]
- Relatively lower demand growth and asset utilisation warrant a less conservative approach (less biased towards encouraging investment).[34]
- With excess capacity present in most networks the balance of risks between too much and too little investment has shifted and consumers suggest that they are not concerned about too little investment in the next period due to the large amounts of investment over the past decade.[35]

Draft Guideline – Cost of Equity



Draft Guideline – Cost of Equity

AER uses the **Sharpe-Lintner CAPM** to estimate the cost of equity.

$$r_e = r_f + \beta * MRP$$

Market Risk Premium

- Reduced from 6.5% to 6.0%.
- Place weight on geometric means, despite no expert support for this
- Did not place weight on the DGM due to concern about long-run growth assumptions

Equity Beta

- Previously 0.7 from a range of 0.4-0.7. Now 0.6 from a range of 0.4-0.8. Wide range of empirical estimates.
- Best statistical estimate has increased since 2013 but less of a role given to the 'theory of the Black CAPM' and low beta bias

Draft Guideline – Cost of Equity

Table 31 Re-levered weekly equity beta estimates from AER update (OLS, weekly)

		P1	P2	P3	P4	P5	P6	P7
Firms	Avg of firm estimates	APA, ENV	AAN, AGL, APA, ENV, GAS	APA, DUE, ENV, HDF, AST	APA, DUE, ENV, HDF, SKI, AST	APA, DUE, ENV, SKI, AST	APA, DUE, SKI, AST	APA, SKI, AST
Equal weighted								
Longest available period	0.57	0.48	0.50	0.54	0.53	0.43	0.47	0.52
Post tech boom & excl. GFC	0.61	0.52	0.51	0.59	0.58	0.50	0.54	0.63
Recent 5 years	0.70	0.71				0.55	0.66	0.79
Value weighted								
Longest available period	n/a	0.52	0.66	0.47	0.47	0.44	0.49	0.54
Post tech boom & excl. GFC)	n/a	0.56	0.67	0.55	0.55	0.52	0.57	0.66
Recent 5 years	n/a	0.73				0.53	0.72	0.85

Source: AER analysis; Bloomberg

Note: Our comparator firms include AusNet Services (AST). This firm was included in the 2013 Guidelines under its former name of SP Ausnet (SPN). It was renamed in 2014.

Draft Guideline – Cost of Debt

- Benchmark term of debt = 10 years
- Benchmark credit rating = BBB+
- Transitioning to a trailing average approach: 10% of debt costs updated each year
- Use RBA and Bloomberg BBB yield curves to set debt based on a short period of time (10-20 days)
- Benchmark gearing = 60%

Changes in Draft Guideline

- Addition of a new curve, Thompson Reuters, to setting the benchmark cost of debt
- 1/3rd weight will be placed on corresponding A-band curves, reducing the cost of debt allowance by around 15-30bp per annum

Draft Guideline – Value of Imputation Credits (Gamma)

- **Deduction from the corporate tax allowance to reflect the value of dividend franking to equity investors, thus reducing the effective cost of equity**
- **Comprises a distribution rate and a utilisation rate**
- **Value has increased from 0.4 to 0.5 (within a range of 0.3 to 0.6), based on:**
  - Updated ABS data on equity ownership, to set utilisation rate
  - Placing less reliance on ATO data to set the distribution rate