Online forum
Rate of return working papers

Return on equity

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11 August 2021, 2.30 pm to 5:00 pm

Agenda

Time	Duration	Item	Presenter
2:30	5 min	Check in period	
2:35	5 min	Welcome and Introduction	Warwick Anderson (Chair)
2:40	15 min	Overview of working paper	Eric Groom, PSM, AER Board member
2:55	45 min	Stakeholder Presentations	CRG, NSG, APGA
3:40	10 min	Break	
3:50	45 min	Stakeholder Presentations	ENA, MEU, NICE
4:35	20 min	Other presentations and questions	
4:55	5 min	Next steps	Warwick Anderson

Overview of the working paper

Eric Groom, PSM, AER Board member

Context and background

- Working paper program so far:

	Title	Draft paper	Forum	Subs close	Final paper
2020 working papers					
1	Energy networks debt data	26 Jun	29 Jul	14 Aug	18 Nov
2	International regulatory approaches to rate of return	27 Aug	16 Sep	9 Oct	16 Dec
3	Capital asset pricing model and alternative return on equity models	27 Aug	16 Sep	9 Oct	16 Dec
2021 working papers					
4	Term of the rate of return	21 May	15 Jun	2 Jul	Sep
5	Rate of return and cashflows in a low interest rate environment	21 May	23 Jun	2 Jul	Sep
6	Overall Rate of return	15 July	4 Aug	27 Aug	Nov
7	Debt Omnibus	15 July	9 Aug	27 Aug	Nov
8	Equity Omnibus	15 July	11 Aug	27 Aug	Nov

Introduction

- What is the purpose of our working papers

- Decision making framework

- Return on equity framework

- Topics covered in this paper

Return on equity framework
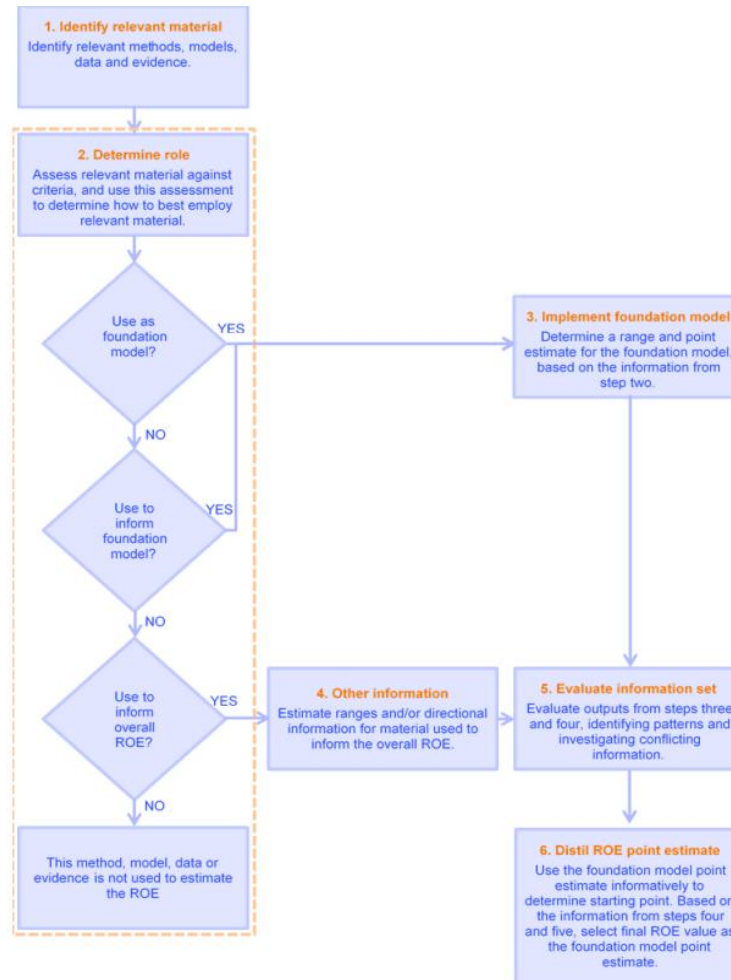
Topic covered in this paper

- Estimating a forward looking market risk premium

- The relationship between the risk free rate and market risk premium

- The comparator set and estimation period of equity beta

- The use of cross checks at the overall return on equity level

- The equity beta for electricity vs gas networks

- Averaging period — nomination window for equity

Estimating a forward looking market risk premium

- Preliminary view: historical excess returns will continue to be a primary input in estimating MRP. Will consider:
  - Arithmetic and geometric mean estimates
  - New/revised estimates of historic returns

- We are interested in stakeholders feedback on whether our estimates of the MRP could be improved by employing dividend growth models (DGM)
  - And other relevant information

- We note that if the return on equity term is changed from 10 to 5 years, then this would also impact the MRP.

The relationship between the risk free rate and market risk premium

- We have not landed at a position in this draft working paper and we continue to assess evidence of a potential relationship

- We remain of the view that any approach we adopt must be capable of being implemented in a manner that is sufficiently robust, transparent and evidence based to be suitable for regulatory purposes

- We welcome stakeholder views on the potential for a relationship and proposals for an appropriate implementation that would be consistent with these aims.

Comparator set and the estimation period of equity beta

- Preliminary view: continue to use our existing comparator set to estimate equity beta

- Not inclined to include international firms

- Propose to give most weight to estimates from the longest estimation period to inform equity beta

- Open question: would equity beta methodology need to change if we shifted to a five year term?

The use of cross checks at the overall return on equity level

- Preliminary view: we should use cross checks to sense check our overall return on equity point estimates.

- At this point of time, we propose to maintain and apply the cross checks in line with the approach we adopted in the 2018 Instrument.

- Key questions: for submissions which cross-checks and how can they be used in a binding instrument?

The equity beta for electricity vs gas networks

- Preliminary view: single beta across electricity and gas businesses

- At this point of time, we have not received new evidence to suggest a change to our approach.

Nomination window and averaging period specification for equity

- Preliminary view:
  - shift the allowed nomination window forward in time by one month to lessen timing issues
  - Continue flexibility for networks to nominate averaging periods

Questions?