# Draft Rate of Return Guideline

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**2 August 2018**

# Thank you

- For attendance this afternoon
- For your engagement and assistance in developing the draft
  - Very useful and informative
- Look forward to future contributions to assist in finalising the guideline
- High level overview of key elements of the draft

# Process

- Consultation paper on process – July 2017
- Public forum – September 2017
- Issues paper on approach – October 2017
- Position paper on process – November 2017
- Expert session 1 and issues paper – March 2018
  – Gearing, financial measures, risk, judgement
- Expert session 2 and issues paper – April 2018
  – Gamma, equity beta, MRP, averaging period and automatic application
- Joint expert report – April 2018
- Issues paper on debt – May 2018

# New legislation – binding instrument

- On 15 June 2018 CoAG EC agreed to new legislation
- Key features
  - rate of return instrument to be binding
  - RoR to be estimated automatically:
    - Formula or value
- Timing of passage through South Australian Parliament is anticipated for this year
- In view of proposed new legislation, we have designed the guideline to be consistent with both current and proposed legislation
  - Return on equity expressed as a formula
  - Tightened requirements around nomination of averaging periods

# Diversity of submissions

- Industry and investors
  - value certainty and predictability
  - the current rate of return is about right (if a little low) and
  - the 2013 Guidelines have been contributing to achieving the NEO and NGO
- Consumers
  - the starting points for the parameters need reconsideration
  - the current rate of return is too high and has not achieved the NEO
  - consumers themselves are facing large risks associated with increasing energy prices
  - with excess capacity present in most networks the balance of risks in promoting investment has shifted

# Overall framework

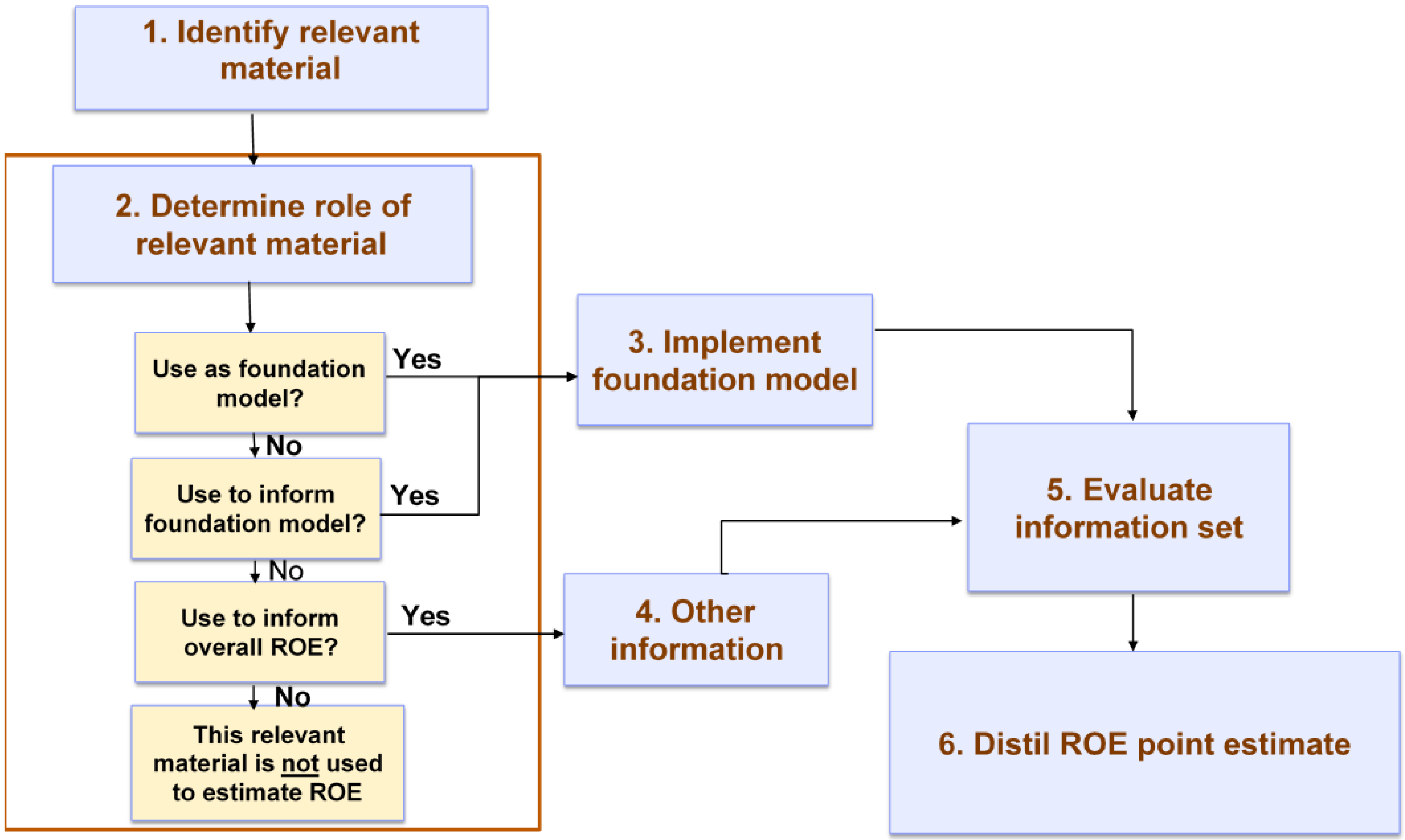
- Largely remains unchanged from 2013
  - Broadly supported in consultation
- Key features:
  - Vanilla WACC $WACC = E(ke)(1-G) + E(kd)G$
  - Gearing 60%
  - Equity: Foundation model with SLCAPM
  - Debt: trailing average with revenue neutral transition
  - Debt: estimated from published third party curves
  - Imputation credits: utilisation approach

# Our approach

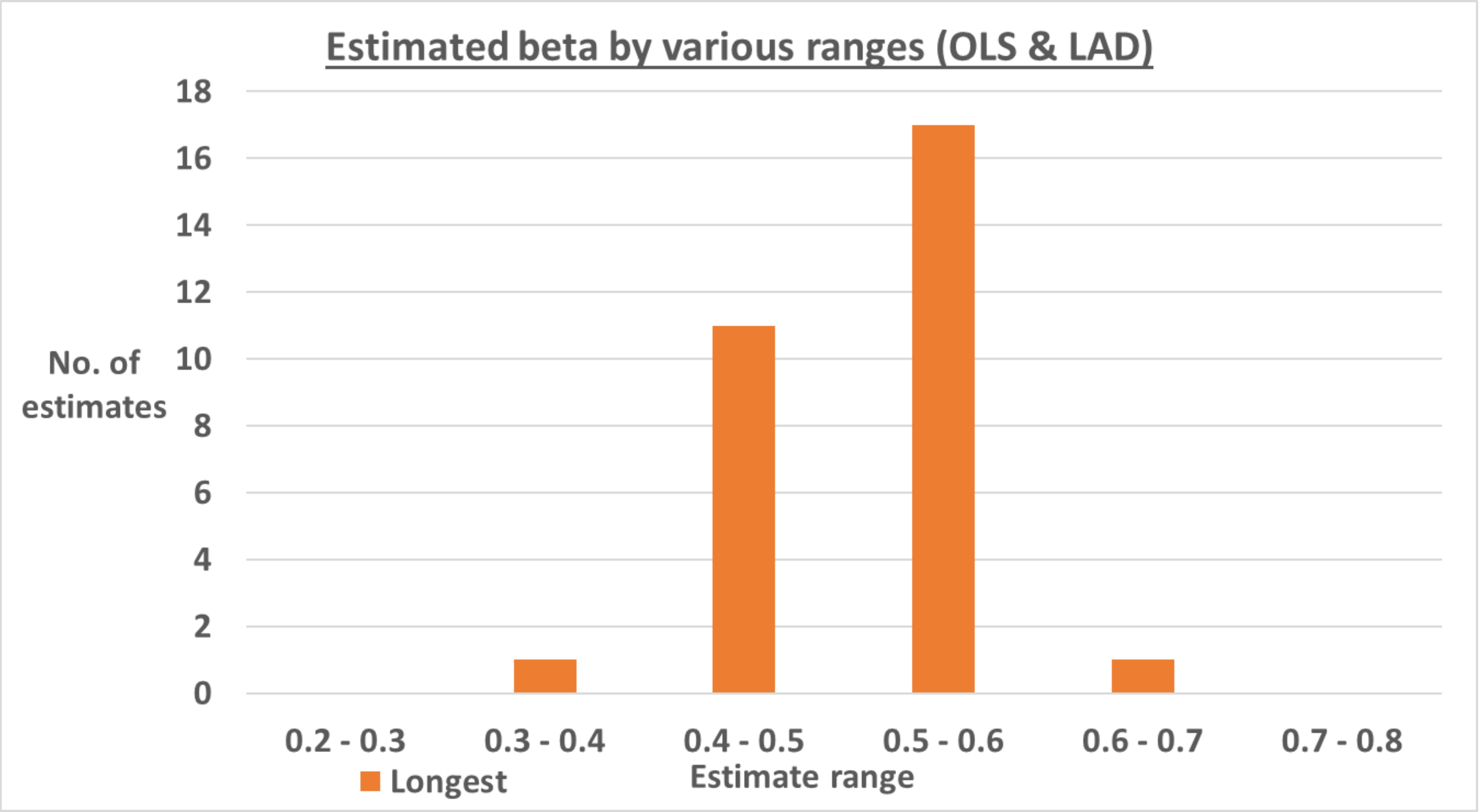
- While broad support around the overall framework
- Sharp disagreement about how the framework should be implemented
- We have reviewed the merits of available information and updated data

# Equity

# Foundation model



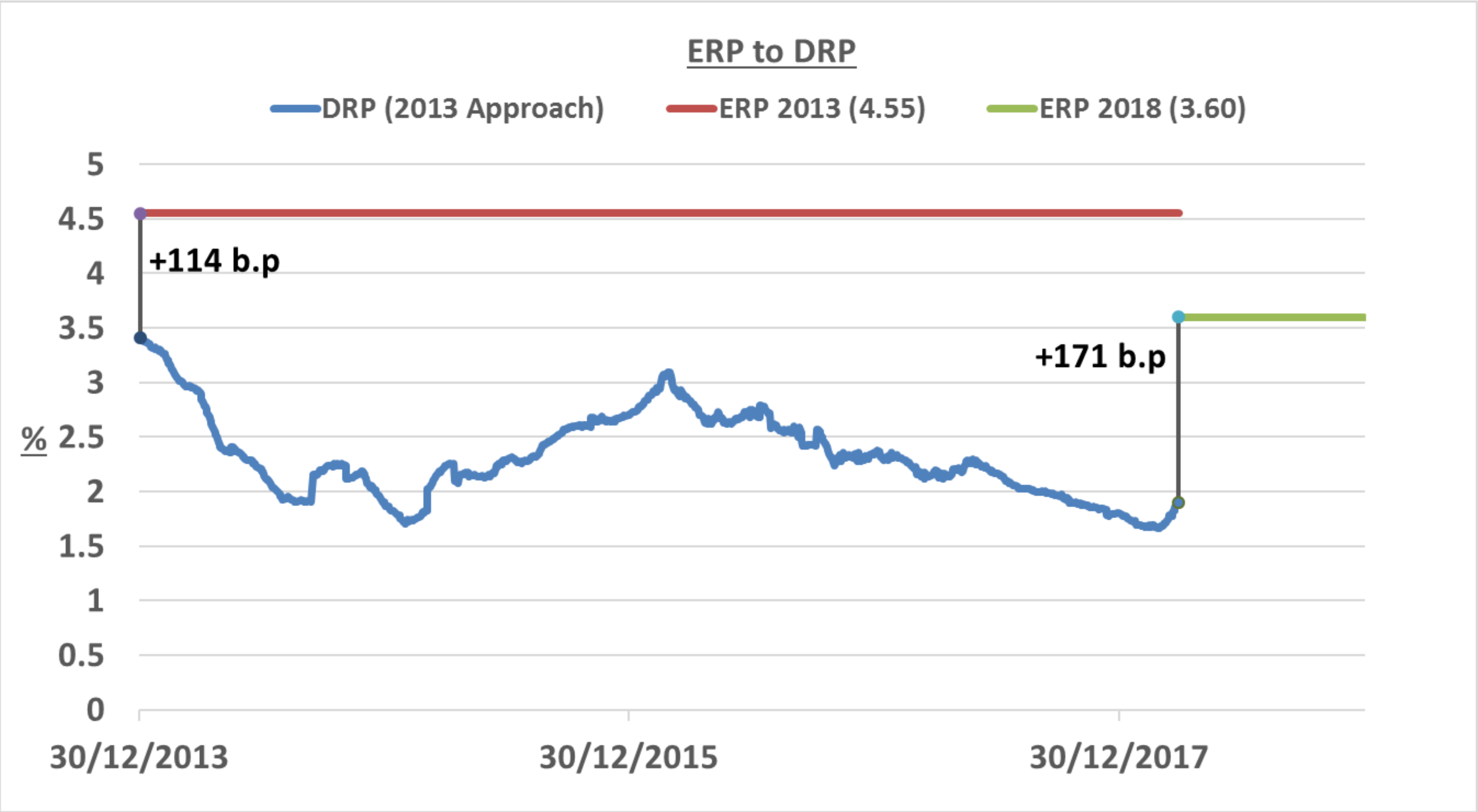
# Empirical estimates of equity beta



# Estimates of historical excess returns

| Sampling period | Arithmetic average | Arithmetic average (2013 guideline) | Geometric average | Geometric average (2013 guideline) |
|---|---|---|---|---|
| **1883–2017** | 6.3 | 6.3 | 5.0 | 4.8 |
| **1937–2017** | 6.0 | 5.9 | 4.2 | 3.9 |
| **1958–2017** | 6.5 | 6.4 | 4.2 | 3.8 |
| **1980–2017** | 6.4 | 6.3 | 4.3 | 3.8 |
| **1988–2017** | 6.0 | 5.7 | 4.5 | 3.6 |

# Overall return on equity

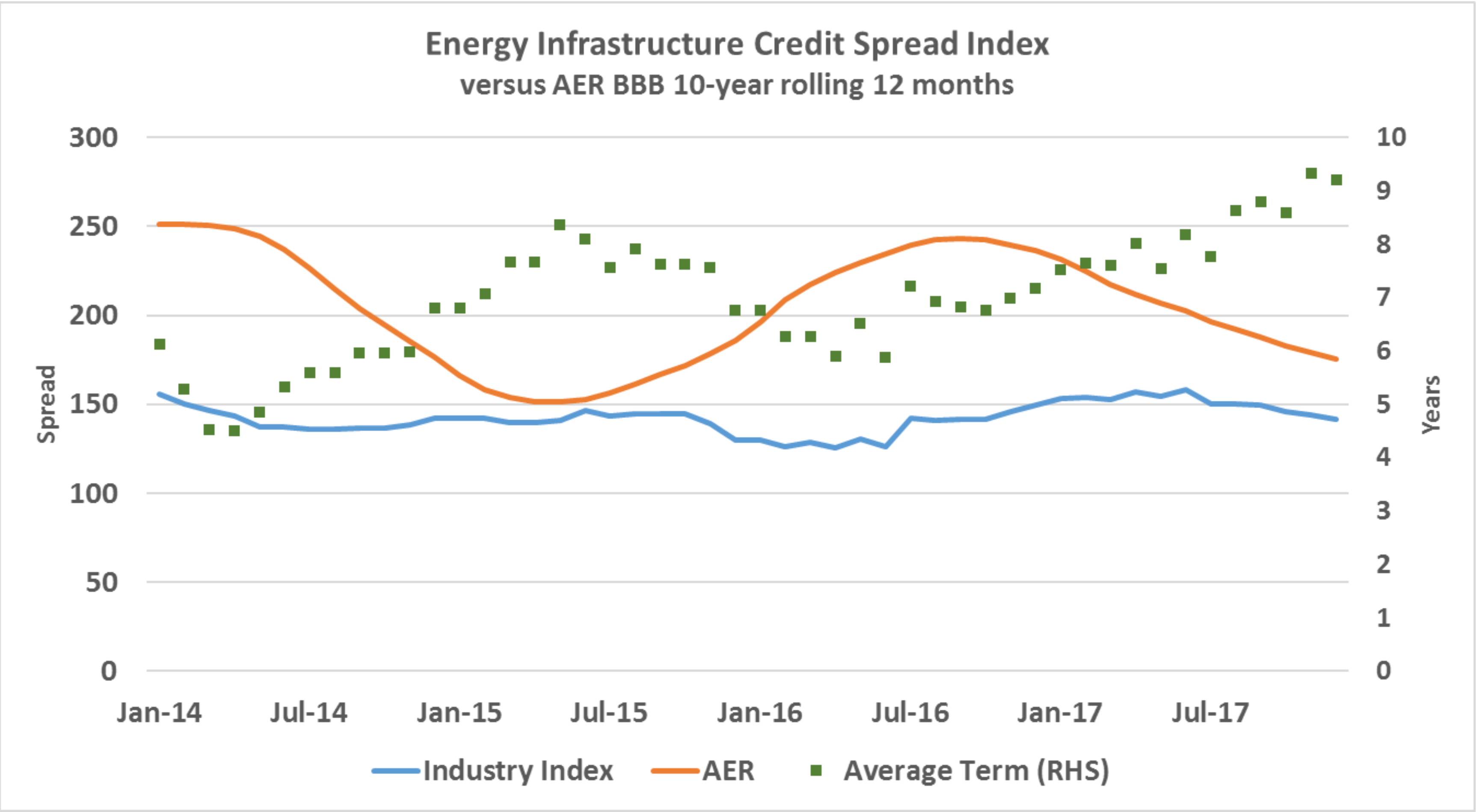


# Debt

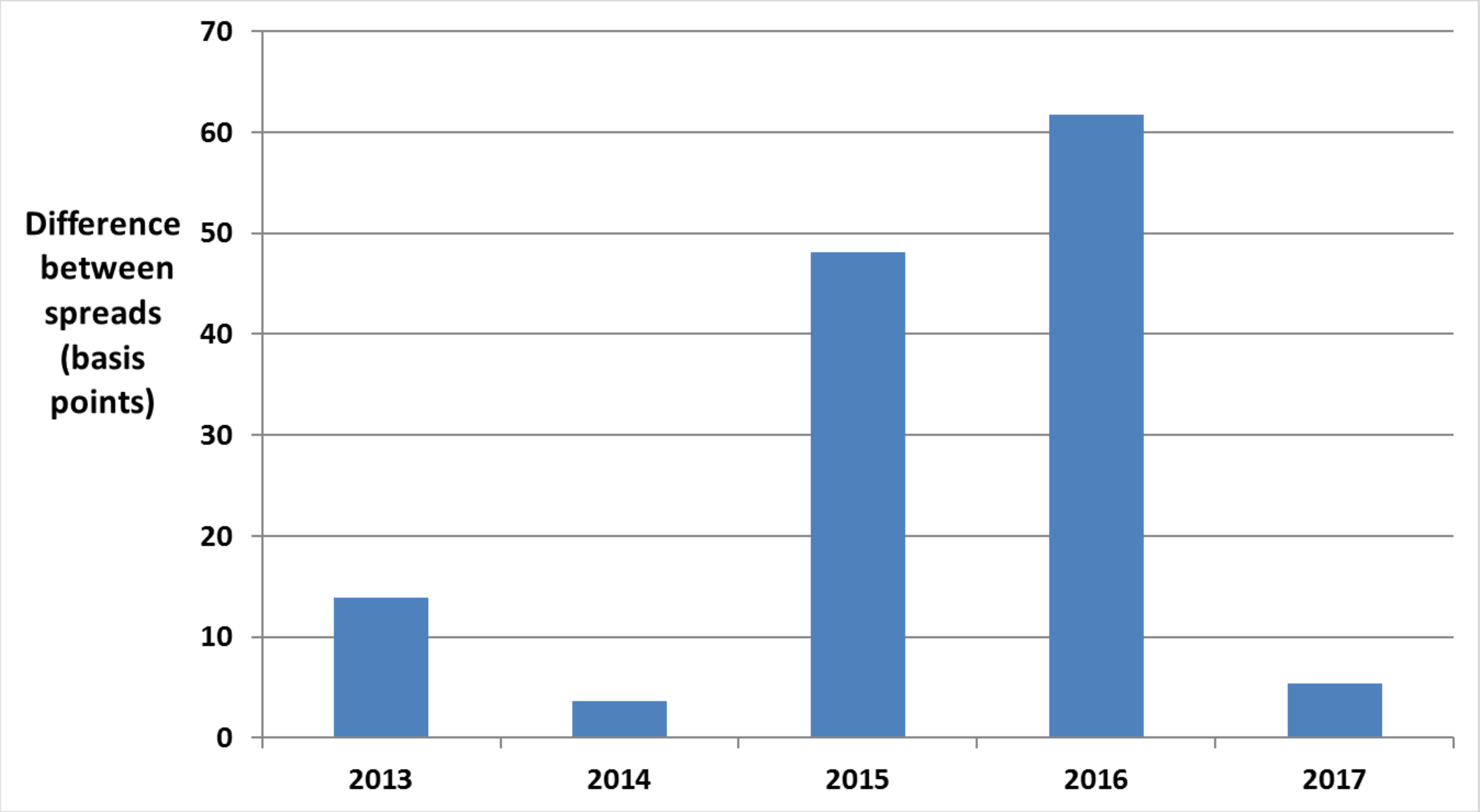
# Median credit ratings

| Issuer | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Industry median** | BBB/ BBB+ | BBB/ BBB+ | BBB+ | BBB | BBB | BBB | BBB | BBB/ BBB+ | BBB+ | BBB+ | BBB+ | BBB+ |

# Actual debt costs



# Debt at matched terms



# Imputation credits

# Imputation credits

- Continued use of utilisation approach to estimating imputation credits
  – As confirmed in Court decisions
- Corresponding with the ATO to understand published data
  – ATO has advised a range of concerns
- The best available data leads us to a value of 0.5

# Incremental review

- Not starting from a blank sheet:
  - Important to build on the methodology developed in 2013 as tested and refined through determinations and Court processes.
  - But also not to limit or dismiss issues.
- Critical objective is to develop a guideline that advances the NEO and NGO.
- We acknowledged that there were diverse views around the concept of a targeted or incremental review.
- Our view was to leave the overall framework in place but to considered the most up to date data and information and its merits.
  - This is what we have done.

# Exercise of judgement

- Ultimately this is a process where we are looking into the future
- Approach in this draft
  - Develop a framework for considering information
  - Assemble all of the information that can inform the outcome
  - Assess the merits of that material and qualitatively fit it into the framework
- Our view is that this is a process that is not amenable to quantitative weighting or developing a base line approach
- Ultimately focus is on the NEO and NGO

# Capable of acceptance

- Building a process where all views can be heard and considered
- Direct engagement between CRG, ENA and IRG
  - Positive
  - Build a relationship
  - Share views and understand differences
  - Explore common ground
- Submissions and expert sessions
  - Some commonality in terms of framework to be employed
  - A divergence of views about implementation of the framework and parameter choices
- AER exercise of judgement

# Process from here

- Independent panel review
  - In your view, is the draft guideline supported by sound reasoning based on the available information such that it is capable of promoting achievement of the NEO/NGO?
  - Seek to reach consensus
  - Report in early September
  - Transparency in respect of requests for information – published on our website
- Submissions due mid- September
- Final guideline in December