APGA
50 YEARS 1968–2018

AER Rate of Return Guideline
APGA Perspectives

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Process

- Liked the expert sessions
  - Gave the AER enough to go on - mostly
  - We structured our submission directly around a “pragmatic next steps” approach.
- Transparency and regulatory judgement
  - CFA – “basis that can be established as reasonable” – are you asking the right experts on how to be transparent?
- Consistent treatment of evidence
  - Eg – Frontier vs Damodaran DGM, FFM vs Satchell responses to CAPM problems

The easy bits

- Gearing
  - 60 percent seems clearly accepted view
- Debt
  - Stay the course with trailing average
  - Some concerns about different indices and Chairmont work, but we’re dealing with that elsewhere and still getting across evidence.
- Risk-free rate
  - Allowing longer averaging periods seems uncontroversial

Pragmatic solutions within reach #1

- Gamma
  - Experts agree – we are outside the realms of principle
    - We have no interest in arguing this on principles.
  - The Wheatley pragmatic tax statistics approach:

$$\begin{aligned}&benchmark\ gamma\\&= tax\ stats\ economy\ wide\ gamma \times \frac{benchmark\ firm\ specific\ distribution\ rate}{tax\ stats\ economy\ wide\ distribution\ rate}\end{aligned}$$

  - Accept need to check potential tax stats problems.
  - Avoids unstudied problems with ABS data
  - Pragmatic focus on getting a number

Pragmatic solutions within reach #2

- MRP – where experts agree more than they disagree
  - We think historical, arithmetic mean as lower bound
  - DGM must be in mix & we think one DGM as upper bound
    - Issue is on dividend growth rates – Wheatley solution of tying them to something which can be verified as good proxy like GDP growth rates
    - Lots of DGM estimates just looks like robustness
  - We think start in the middle, link movements away to evidence, and rank importance of evidence to provide clarity of what factor drives what movement.
    - Faith in DGM estimates (in general or specific) could be a reason
    - Evidence from the Wright CAPM could be a reason
    - AER indicator variables could be reasons
  - Not perfect, but experts agree there is no perfect, principled way

The perennial argument

- Beta – some agreement, but not enough to get an answer
- We think two steps:
  - Current trading energy businesses, but calculate confidence interval
  - Narrow interval secondary information (de-listed firms, international energy, domestic infrastructure)
    - Will require judgement, but maybe some objective ways to link datasets first – Kolmogorov-Smirnov, Singer Terhaar – maybe?
- We think do fewer regressions in step 1 (4?), but consider shorter time frame to capture new market information
  - 5 years considered standard in finance
- Gas and electricity are different, so we think the AER should give serious consideration to differing betas for gas and electricity
  - NZCC approach
  - Available evidence

The stalking horse

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- Low beta bias – all experts agree actual returns exceed CAPM predictions, but what to do:
  - Vague references to “theory of the Black CAPM” do not satisfy stakeholders
  - “Expected equilibrium framework” is a logical mess.
  - Empirical difficulties do not excuse doing nothing, nor do guesses that it might go away.
  - Actual historical scale of bias in Australia is in the order of 400-500 bps
    - Stretches all credibility to assume investors give this no mind
  - Need a starting point for sensible empirical analysis:
    - HK for Multinet – lowball the estimate.
    - Brav et al show approaches using expected returns
  - We expect judgement to play a role, but judgement must be credibly informed