AER Consumer Reference Group

AER Public Forum

CRG's preliminary response to the AER's Overall rate of return – Draft Working Paper

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Part A:

1) Overview of AER rate of return approach

2) Decision making framework

3) Assessment criteria

The big picture

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- Revenue decisions are made in 5-year ‘slices’ & the RoRI in 4-year ‘slices’
- The RoRI sits within a broader regulatory framework, bound by the energy laws and rules where the overriding objective is:
  - **to best satisfy the long-term interests of consumers**
- And it does this by :
  - **promoting efficiencies in two pillars, investment & consumption**
- RoR sits within a single conceptual and legal framework
  - **But is made up of individual parameters & decisions**
- Estimating RoR is not a precise science & requires multiple regulatory judgments
  - **AER’s judgment is guided by principles & criteria**

Conceptual framework in LTIC context

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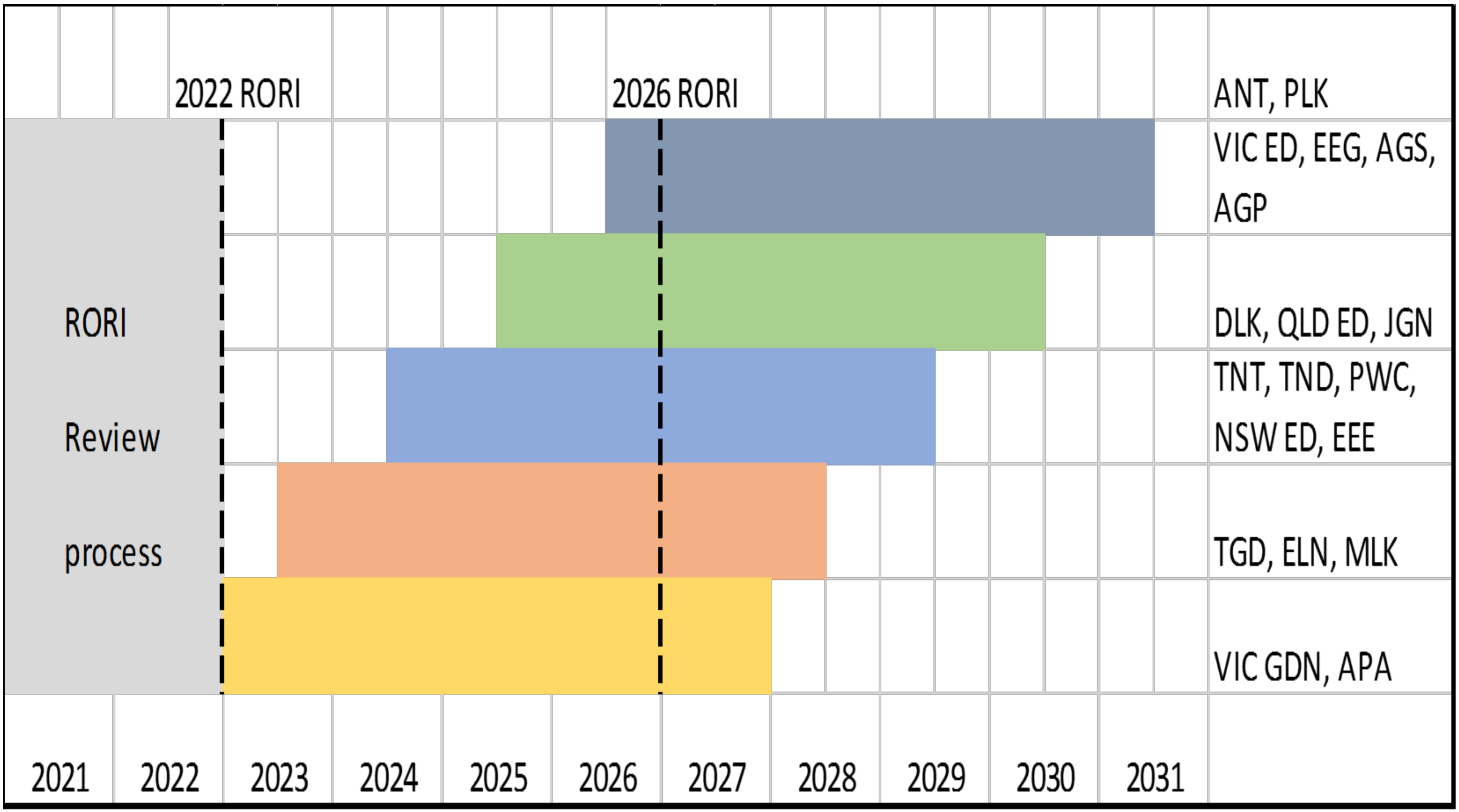
- **CRG is seeking a clear statement on the AER's overarching conceptual framework**:
  - Long-term interests of consumers, NPV=0 over life of assets, long term investment horizon (all proxied by a 10-year view on bonds/equity/inflation). OR
  - Focus on NPV=0 in a regulatory period, implies a shorter term investment horizon
- **Why does this matter?**
  - Longer term view looks through business cycles
  - Shorter term view places more emphasis on near term conditions
  - Impacts on the type of modeling and data that is relevant
  - Provides an underlying rationale for consistent decisions across parameters
- **Which framework view is more consistent with the 'real world' acts of investors and consumers**?
  - Limited evidence, but to date suggests investors take a long view; and
  - Consumers take long perspective when investing in DER, PV etc
- **Practical considerations**
  - The 2022 RoRI will impact on the AER's decisions from 2023 to 2032

RoRI and the AER's regulatory determination timetable

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Conceptual framework & LTIC

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- Whatever conceptual framework is adopted, the NEO/NGO defines the objective
- The AER defines the LTIC in terms of an ***"unbiased"*** estimate of the RoR
- An alternative/supplementary view might be to adapt the capital investment criteria in the National Gas Rules ("conforming capex"), i.e.:
  - *Capex* [RoR?] *that would be incurred by a prudent service provider acting efficiently and in accordance with good industry practice,* ***to achieve the lowest sustainable cost of providing services*** [capital]*[1]*
- The NEO/NGO is an economic efficiency objective with two arms, efficient investment and efficient operation and use of energy services,
  - Overall efficiency objective is achieved through optimisation of supply and demand
  - Traditional focus is on efficient investment – ignores how consumers respond & invest
  - Unbiased assessment of the RoR should explicitly consider both arms
- Achieving efficient outcomes **in practice** should recognise that:
  - Both investors and consumers act on expectations about the future
  - A stable, transparent & fair regulatory regime positively influences these expectations
  - The AER's 6 criteria promote this, as do the CRG's consumer principles
  - CRG pleased to see AER introduce new criteria– 'materiality, longevity and sustainability'

1 See National Gas Rules, rule 79(1)(a). A similar requirement is in the National Electricity Rules (NER, S6.2.2(4))

Other matters – beware the special pleadings

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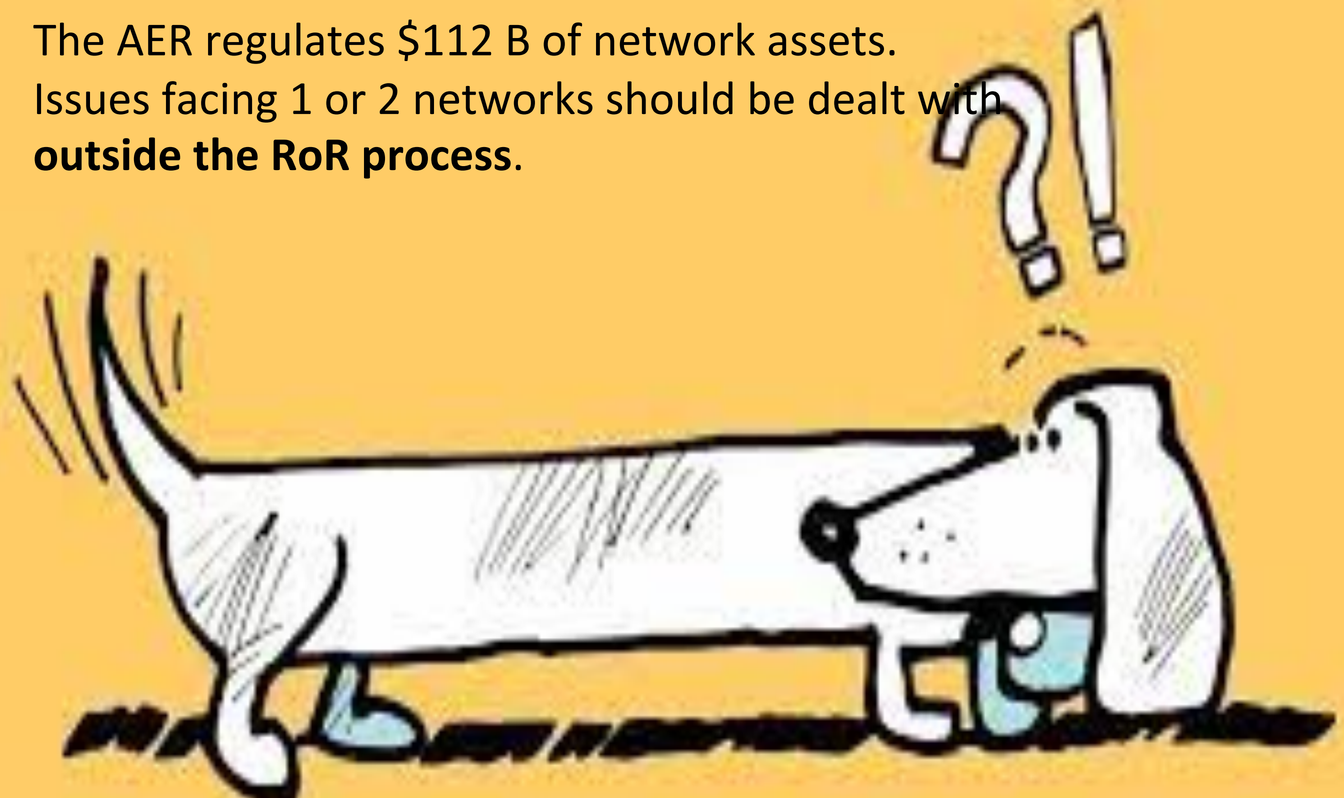
The AER regulates $112 B of network assets.
Issues facing 1 or 2 networks should be dealt with **outside the RoR process**.



Part B

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(1) Form of the rate of return ✔

(2) Gearing

(3) Gamma

(4) Use of cross checks at the overall rate of return level

CRG's starting point

What is the evidence for change from the 2018 position and does such evidence meet the threshold for change?

Estimating benchmark gearing ratio

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- **2018 RoRI:** Gearing of 60%, focus on market values rather than book values
  - AER now investigating a change to 55%
- **Evidence:**
  - Small reduction in gearing based on market values, but book values are higher and more stable
  - Market value trends can be distorted by fluctuations in equity prices
  - Changes in gearing +/-5% have little effects on financial metrics
  - Variation in how international regulators treat gearing
- **CRG's preliminary view**:
  - AER take more account of book values (5yr & 10yr)
  - Overall impact on RoR unclear because of impact of gearing on other parameters
  - Does not appear to pass the materiality/high bar for change
  - Insufficient evidence overall, to change from current 60%

Gearing & hybrid securities

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- **2028 RoRI position**: Adopt different approaches depending on circumstances
  - AER now considering a more consistent approach
- **Evidence:**
  - For ASX listed companies – AER observes increase in hybrid securities
  - Hybrid security markets have a wide range of terms & conditions
  - Limited impact (to date) on gearing ratio for listed companies
- **CRG preliminary view**:
  - AER's gearing model is a simplified representation of current market. Recognising hybrids may open door to significantly more complex models
  - There is no easy single rule to allocate all hybrids between debt and equity
  - Products are getting more complex and (?) less transparent
  - Suggest AER continue to monitor materiality of the hybrid market
  - Maintain current practice of not allocating hybrids, unless they closely approximate debt instruments

Estimating the value of imputation credits (gamma)

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- **2018 RoRI position**: Adopt the 'utilisation' approach, measured as the product of the estimated payout ratio for the benchmark firm and the economy wide utilisation rate.
  - AER proposes to maintain this approach but review some data inputs
- **Evidence:**
  - Estimation of utilisation rate is sensitive to the data used
  - In 2018, the ATO data was not 'fit for purpose'
  - AER waiting for data from the ATO – preliminary analysis suggests that 'net franking data' (ATO v2) has some benefits compared to ABS data
  - Very limited reliable & consistent data on the utilisation rate of imputation credits by non-resident investors
- **CRG's preliminary position:**
  - AER should continue to use the 'utilisation' approach
  - Request additional evidence that the payout ratio of the top 50 ASX firms represents the benchmark regulated network firm
  - Subject to additional data from the ATO, there are benefits in using this ATO net franking data to inform the estimation of the utilisation rate
  - Absent additional relevant data from the ATO, retain assumption that non-resident investors derive no value from imputation credits

The role of cross checks in the RoR (1)

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- **2018 RoRI**: Cross checks may provide contextual information, but not useful in directly informing the RoR.
  - AER considering financeabiltiy cross checks, with others providing 'contextual information'
- **Evidence:**
  - AER profitability review, & enhanced network performance reports provide greater insight
  - Networks remain profitable & transaction RAB multiples continue to be around 1.4 to 1.6.
  - Networks underspend the AER's capex allowance – but also propose capex in excess of the AER's allowance
  - No evidence to date of a systematic financeability problem,
  - Changes to estimation of expected inflation have improved cash return position
- **CRG Preliminary Position:**
  - Cross checks provide some contextual information on historical outcomes & future expectations, but are not determinative as individual metrics.
  - Taken as a group, they may guide the AER's judgment (within guard rails of the empirical data)
  - Additional care in using 'investment' trends, & in any more direct use of financeability metrics
  - Cross checks must act symmetrically

Example: Real and nominal RoA above allowed RoA, but is trending down *What factors drive this?*

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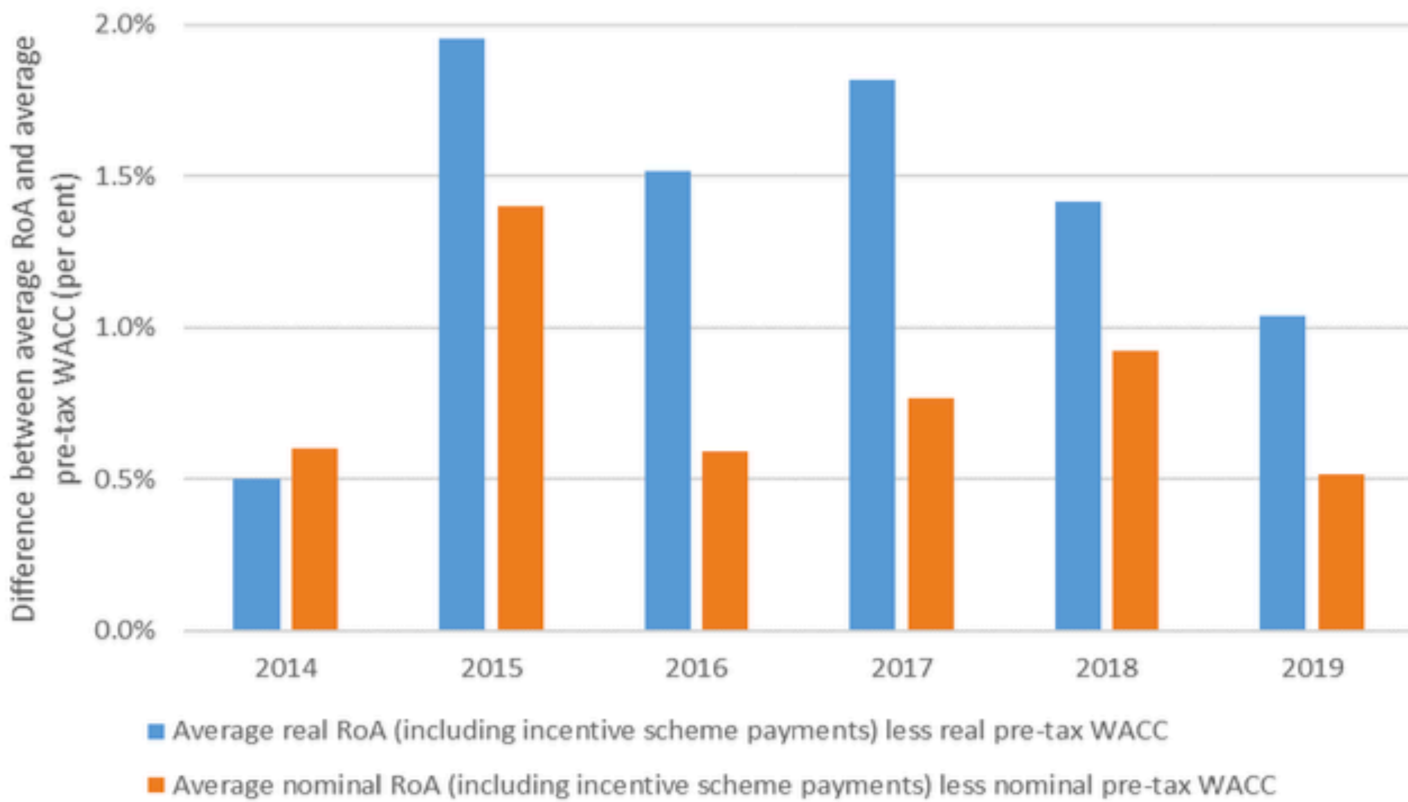
Figure 6-5 Average return on assets – comparison of actual returns against allowed returns – Real and nominal returns – DNSPs and TNSPs



Source: Financial performance data, AER analysis

Networks typically spend less than AER's allowance – but requested more! Why?

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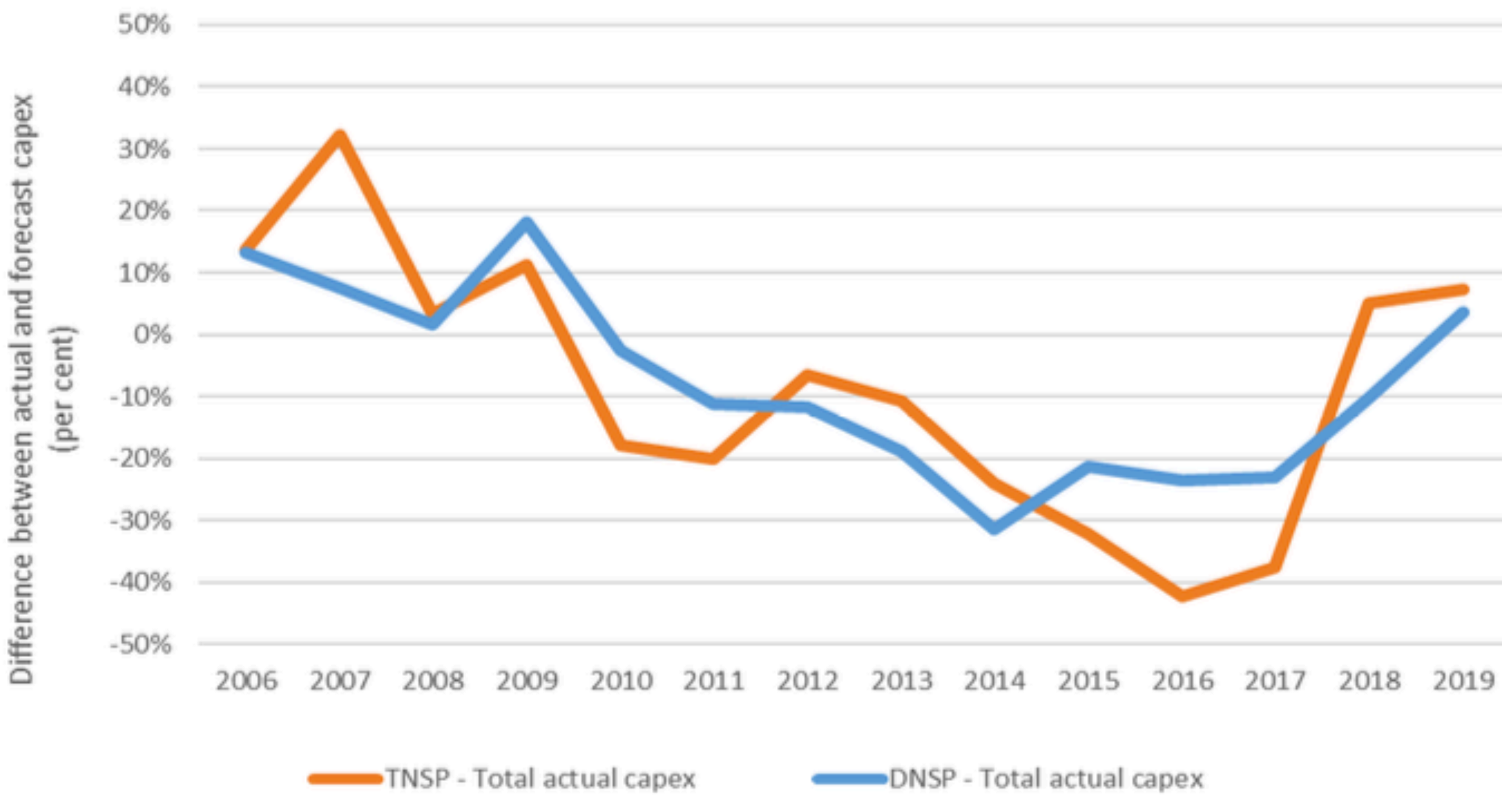
Figure 4-8 Capital expenditure – Differences between actual and forecast capital expenditure



Source: Operational performance data, AER analysis.