RATE OF RETURN GUIDELINE – WORKSHOP, 18 SEPTEMBER 2017 INVESTOR GROUP

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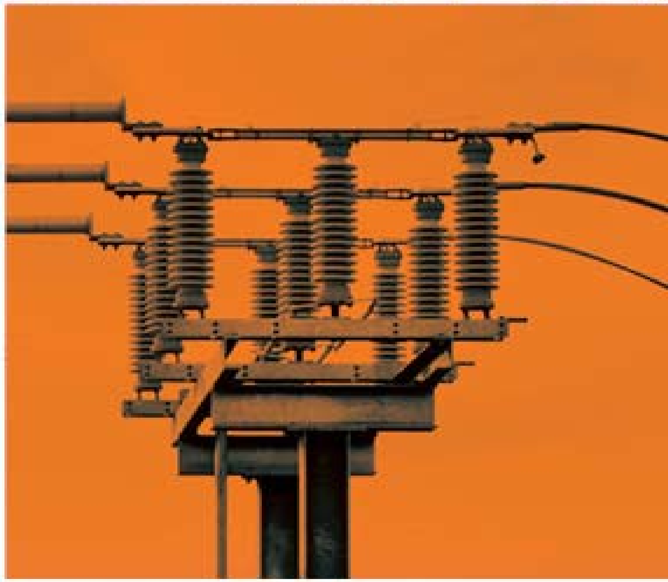
THE AUSTRALIAN INFRASTRUCTURE NETWORK SPECIALISTS



Investors as stakeholders

- Private investment is critical to support the change underway in the Australian energy sector and in providing sustainable and efficiently priced energy to consumers
  - e.g. Finkel Report blueprint, transitioning to renewables, more dispersed generation, and more consumer engagement and involvement, including demand side management
- More investment is needed to support the AEMO integrated grid plan for the future, which will also remove transmission constraints and lower prices to consumers
- Private ownership of electricity networks has increased from 25% to 55% of industry RAB value* across the NEM since the last time the ROR Guideline was reviewed in 2013
  - TransGrid ($6.1bn RAB)
  - Ausgrid ($14.7bn RAB)
  - Endeavour Energy ($5.9bn RAB)
- The six investor signatories have invested more than $12 billion in energy networks in NSW, Victoria and South Australia.
  - NSW – TransGrid, Ausgrid and Endeavour Energy
  - Victoria – CitiPower and Powercor
  - South Australia – ElectraNet and SAPN

*RAB values as at 2016 from AER State of the Energy Market Report, Table 3.1 and 3.2, May 2017

AER's ROR Guideline process paper

- Investors welcome the AER's initiative to engage on the process for the ROR Guideline review and taking a fresh approach to the methods used to engage effectively
- The new approaches will improve the effectiveness of engagement in identifying relevant information and impacts of the rate of return on investments in energy network businesses.
- The establishment of an investor reference group will facilitate options to be explored, early identification of issues and collaboration in resolving them.
- In particular, the investor group can help test methodologies for estimating the efficient cost of debt and required returns on equity and the overall impact on finance-ability
  - Expertise and real life experience in raising debt and equity and factors that affect value and risk
  - Provide current investor views of acceptable risk and investment parameters to ensure necessary equity capital is available to fund network businesses over the ensuing regulatory periods
- A collaborative process followed by ongoing transparency and predictability of the rate of return will support the attraction of sufficient capital at the lowest cost to customers.

Investor's seek investment certainty and stability

- Financial investors seek a regulatory regime that provides ongoing confidence to invest efficiently
  - The Rate of Return Guideline should provide a regulatory commitment to stable and predictable returns on investment over the life of the investment (> 50 years)
  - The processes for determining the rate of return should be transparent with predictable in any given market conditions
- These are the conditions required to ensure sufficient and efficient low cost financing
- Important to develop a framework for assessing objectives – rate of return objective and long term interests of customers
  - There will be conflict between prices to customers and returns to investors
  - A principle based approach that supports an efficient cost of capital – even when it needs to be higher
  - Long term interests of consumers in terms of price and service are best served where there is investment confidence in the ability, and an incentive, to sustain efficient levels of investment

Issues to consider – process and substance

- Clarity
  - Proportionate approach to contentious issues - some issues are non-contentious, it makes sense to identify these early and lock them down
  - Consider the impact on incentives – the incentive framework expects businesses to outperform to achieve greater returns so customers benefit over time
  - Conditions that might give rise to changes – when would the value, method or data be expected to change and why?
    - History/historic market conditions may not be an appropriate indicator for the future (and may not be sufficient to attract the necessary capital)
    - GFC conditions
    - Extraneous impacts (e.g. Government interventions)
  - Implementation consistency – ensuring the approach to estimating the efficient rate of return is faithfully captured in the modelling
  - Estimating approach – method vs estimate, prescription vs discretion, prescribed data and weighting
- Safe environment to engage and advance ideas
  - Test rather than assume bias for all stakeholders
  - Seek understanding - walk in the shoes of each stakeholder group
  - Expect uncomfortable conversations but ensure disagreement does not become disagreeable

We live in uncertain times…

- Energy policy
  - Clean Energy Target?
  - Coal vs Renewables
  - Technology innovation – firm capacity, batteries, prosumers, demand management, micro-grids
  - Ancillary services
  - Energy pricing and tariff reform
- Government interventions
  - Federal vs State renewable policies
  - Abolition of LMR
  - Extending lives of coal power plants
  - Providing support for certain industries

“They are looking at the political risk in Australia and saying it’s potentially too risky. Why would we want to commit more capital in this country?”

Policies poor excuse for carbon sins, says investor

AFR 14 September 2017

- The regulatory world cannot operate in a vacuum
  - Regulation (and regulatory outcomes) need to be more dynamic
  - Historical analysis may not be a good predictor for the future….the cost of capital is dynamic and volatile