12 December 2017

Mr Warwick Anderson
General Manager
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Via email: rateofreturn@aer.gov.au

Dear Mr Anderson,

Re: Response to issues paper on the review of the Rate of Return Guideline

As major institutional investors in Australian energy Network Service Providers (NSPs) and representatives of many millions of individual Australian mum and dad investors either directly or through their superannuation holdings, we are writing to outline our views on the Rate of Return Guideline (ROR Guideline).

The Australian Energy Regulator's (AER's) issues paper dated October 2017 (Issues Paper) invites views on the extent to which the AER's current approach to setting the allowed rate of return remains appropriate. We are responding to the Issues Paper with reflections on the AER's current practice in determining the rate of return, rather than solely on the positions and approach outlined in the 2013 ROR Guideline (Current ROR Guideline), recognising that the current practice has departed from the Current ROR Guideline in some respects, and been clarified in others.

We also acknowledge that the AER is not taking a 'blank slate' approach to the review, and agree that there is considerable merit in maintaining consistency of approach and settling positions or approaches where this can be done. We also welcome the opportunity to investigate and hopefully settle unresolved issues where differing views remain through the AER's improved interactive engagement process.

Our contribution to the review is guided by the national energy objective to promote the long-term interests of consumers (who in many cases are also investors in NSPs). We are not seeking precision on each individual parameter. However, we are seeking an outcome that is consistent with the allowed rate of return objective (ARORO). That is, the allowed rate of return is commensurate with the efficient financing cost of a benchmark efficient entity (BEE) with a similar degree of risk. We consider that an approach that provides consistency, predictability, transparency and appropriate flexibility is required to achieve this.

We encourage the AER to consider and settle issues through this review process with the following in mind:

- Transparency and predictability provides investment certainty which is critical in attracting the right amount of efficient investment at the right time and at the lowest cost. The ROR Guideline must enable investors and NSPs to understand the regulated rate of return that would apply at a point in time given prevailing market conditions. This is critical given the significant capital sums involved requiring ongoing access to a variety of global capital markets and where investment (capital expenditure) is made for the long-term (40-50 years) but rates of return are re-set each 5 years. Hence, the objectives of transparency and predictability must extend over many regulatory periods.
- The framework for incentive based economic regulation is working as intended. The incentives to deliver outcomes consistent with economic efficiency are working well for profit motivated businesses; costs are lower, and services are improved and will continue to improve further. Incorporating measures of financial performance in assessing a reasonable rate of return is in many cases an "ex post" exercise and has the

potential to weaken the incentives – penalising businesses for delivering outperformance and burdening customers with underperformance.

- Material instability in the energy markets means investor certainty is at an all-time low. Considerable uncertainty in energy policy, significant changes in the way energy networks are being used, high propensity for governments to intervene at will and abnormally low levels of inflation are not appropriately accounted for in past performance. A rate of return commensurate with the efficient financing costs of a BEE with a similar degree of risk must be able to accommodate forward looking changes in markets and risk.
- The concept of the BEE is a critical element of the incentive framework and establishing the regulated rate of return. The opportunity to outperform the benchmark and realise a rate of return greater than the regulated rate of return is a necessary component of attracting investment to the sector and encouraging NSPs and their owners to take a prudent level of risk and run the business as efficiently as possible. Any changes to the benchmark will not only risk an adverse change in behaviour but also break a fundamental principle behind the entire framework. Any change to the benchmark parameters should meet a high threshold and be accompanied by appropriate changes to interdependent parameters to maintain a risk-equivalent outcome. This also ensures that underperformance impacts on the returns to NSPs and does not result in higher costs to customers.
- The rate of return is set on the basis that investors earn a return on efficient investment included in the Regulatory Asset Base (RAB). The value of the RAB is rolled forward in accordance with the rules and only efficient investment can be added to the RAB. To the extent that the value of the RAB is re-visited ex-post, because of a change in the regulatory framework or policy, the rate of return and the BEE will need to be re-visited so that the rate of return continues to provide a return commensurate with the risks. Such a change would reduce the incentives to invest and increase the cost of capital as is outlined in work undertaken by the Energy Networks Association (ENA)[1].

To be clear, we are contributing to this review on the basis that there is no change to the treatment of the RAB from the current National Electricity Rules (NER), or fundamental change to the regulatory framework or policy. Should there be such a change, the rate of return and the input parameters will need to be re-examined.

The remainder of this submission provides a response to the questions posed by the AER in the Issues Paper from the group of six investors that are signatories to this letter (the Investors). The Investors are all Australian-based institutions, representing a majority of local capital including from government and industry superannuation funds, charities, large institutions and retail investors. Collectively, we have invested an aggregate of more than $12 billion of equity across six NSPs in NSW, Victoria and South Australia. Therefore, not only will we be directly affected by the ROR Guideline, we also have relevant and contemporary information and experience to inform the development of the ROR Guideline.

We are pleased that the AER has accepted our proposal to establish an investor reference group and we look forward to working with the AER to test information and approaches to establish the revised ROR Guideline. We will of course also contribute by continuing to participate and contribute to other forums and papers.

We consider that a collaborative process followed by ongoing transparency and predictability of the rate of return will support a positive investment and stakeholder environment that is increasingly vital given the broader developments and dislocation facing the energy markets, and ultimately, will contribute to the efficient investment of capital in the long-term interests of customers.

[1] Energy Networks Association, W*ritten Down Value? Assessing proposals for electricity network write-downs*, August 2014.

We look forward to working with the AER, customers and the NSPs to develop a robust, transparent and fit for purpose ROR Guideline. Please contact Sally McMahon, Economic Regulatory Advisor with Spark Infrastructure (phone: 0421057821) for further discussion or questions.

Yours sincerely,

Rick Francis
Managing Director & CEO
Spark Infrastructure

Terry Winder
CEO
Hastings Funds Management

Michael Cummings
Head of Funds, Australia and NZ – Infrastructure AMP Capital

Nik Kemp
Head of Infrastructure
AustralianSuper

Michael Hanna
Head of Infrastructure – Australia
IFM Investors

Francis Kwok
Co-Head of Asia-Pacific
Macquarie Infrastructure and Real Assets

Attachment: Submission to the AER's Issues Paper on the review of the rate of return guideline

Introduction

The Investors support the AER's approach to reviewing the rate of return by building on the Current ROR Guideline. However, we note that the AER's current practice has itself evolved away from the Current ROR Guideline and so the review process should also take in to account the departures from the ROR Guideline and reasons. The experience over the last 5 years consists of, in some respects, convergence to methods, approaches and values and, in other respects, continued divergence. We support an approach where the convergence can be captured and embedded in the ROR Guideline, and welcome the opportunity to utilise the AER's new approach to engagement to investigate and resolve divergence.

Investors value stability and predictability in the regulatory framework and its application. Ultimately this delivers the 'certainty' that investors value, especially when investing across a multiple number of regulatory periods. On that basis, we are seeking a ROR Guideline that enables all stakeholders to reasonably predict at any point in time how prevailing market conditions will affect the rate of return that the AER will adopt. In some cases, this may mean a specified value where that value can aid certainty without becoming out of step with market conditions. However, in other cases this will require the specification of a method, relevant data sources and potentially the relative weighting given to data sources. This has not occurred under the Current ROR Guideline and we have observed considerable exercise of discretion by the AER on the application and approach to various methods, and the relevance and weight given to information sources.

The investor community feels strongly that continued broad discretion is not appropriate in the absence of Limited Merits Review (LMR); it reduces confidence in the decision-making process and quality of decisions, particularly where it is perceived that discretion places more weight on short term price reductions than longer term sustainable efficient investment and provision of services. If the current level of discretion remains or is increased further in the absence of LMR, the market will require higher returns thereby increasing prices to customers. In the short term the investments made on behalf of numerous Australian superannuation members is likely to be adversely affected by this increased risk.

We support the AER's view that a benchmark approach to determining the rate of return maximises incentives for businesses to minimise financing costs given the risk faced, and is consistent with the approach taken on operating and capital expenditure allowances. There are many benchmark assumptions that have been adopted and accepted over multiple periods that investors see little benefit in re-assessing. We encourage the AER to adopt a high threshold for changes to long-standing benchmarks, and where there is a change, to make the consequential changes to other interdependent benchmarks and assumptions. Importantly, a change to a benchmark must only occur where the expected change in behaviour will provide benefits to customers over the long term and not merely impose additional costs on NSPs as they alter positions to reflect the change in benchmark.

We support canvassing different approaches. However, some of the concepts raised in the Issues Paper are inconsistent with many long-standing, well-understood and widely supported regulatory principles in the Australian energy industry which should not be endangered, namely:

- Providing an opportunity to recover the efficient costs of service delivery over the life of investment – this includes the opportunity to recover efficient operating costs, a return on and of capital and tax;
- Providing strong incentives to outperform benchmarks – the opportunity to outperform the BEE is essential in attracting funds and innovation to the sector; and
- Retrospective resetting (i.e. looking ex-post at a networks profitability) in our view is inconsistent with encouraging innovation and responsible risk taking.

The remainder of this submission responds to the questions raised in the Issues Paper.

Overall rate of return

1. **In your view, to what extent has the current approach to setting the allowed rate of return achieved the National Electricity Objective (NEO) and National Gas Objective (NGO), the Allowed Rate of Return Objective (ARORO), and the related revenue and pricing principles (RPPs)?**

There has been considerable debate over time as to whether the current approach to setting the allowed rate of return achieves the NEO, NGO and ARORO and there is likely little to be gained by looking back. Rather, in this submission, the Investors have focussed on identifying improvements in the approach to the rate of return that we believe will better achieve the NEO, NGO and ARORO. These issues will be covered in response to each of the Issues Paper questions that follow.

Investors see improvements to the overall rate of return could be made by recognising the following:

- Broader risk environment;
- The sanctity of the BEE; and
- The impact on incentives of using performance information to set the rate of return.

Recognising the broader risk environment

The ROR Guideline is being developed against a backdrop of considerable uncertainty about energy market policy and rising government interventionism. Since the Current ROR Guideline was developed, the risk profile for investment in the sector has materially shifted because of the transition from traditional large scale remote thermal generation to intermittent renewable distributed generation, the development of export markets, advancements in technology and innovation, and most importantly the increasing sophistication and assertiveness by energy consumers in the way in which they engage and manage their own energy demand and usage. Most notably, the following has heightened the uncertainty facing investors in NSPs:

- The speed and unilateral nature of the process by which LMR was effectively abolished by the Commonwealth. Despite numerous representations by stakeholders of the impact of this on risk, the AER is yet to acknowledge this in its decisions. Moreover, the abolishment of LMR occurred after the most recent NSW network privatisations, thus altering investors' perception of sovereign risk associated with Australian assets. All investors including those participating in the recent NSW privatisations had anticipated continued access to a streamlined LMR regime
- The propensity shown for governments to intervene to give effect to politically motivated short-term objectives rather than supporting evidence-based policy development and policies designed to deliver sustainable and efficient outcomes over the longer term
- Re-agitation by some stakeholders for retrospective reviews of asset values which would lead to de-stabilising the entire regulatory framework, and increase risk, cost of capital and prices to customers.

We accept that, at times, outcomes may be characterised by market volatility and abnormal events and we seek an assurance from the AER that responses to these events are balanced and acknowledge that efficient costs can increase as well as decrease. For example, where prices have decreased because of softer economic environments (e.g. low risk-free rates), prices must also be allowed to rise when economic conditions change (for example, when risk free rates rise).

Sanctity of the benchmark efficient entity

The BEE is fundamental to the effectiveness of the incentive based framework and is central to establishing the reasonable and efficient costs to be paid for by consumers. If this principle is weakened, overall regulatory risk will be significantly altered, the incentive for businesses to innovate and take prudent risks to deliver ongoing efficiencies will be harmed, and ultimately customers will be adversely affected. Investors view the overall risk around the regulatory framework as a whole and therefore changes to one characteristic of the BEE cannot be considered in isolation.

Nexus between the regulated rate of return and incentives to outperform

Investors are attracted to regulated networks for, amongst other things, the opportunity to earn a return that is higher than the regulated return through driving improvements in efficiency and innovation (balanced against the risk of underperforming the regulated return if they do not act efficiently). The AER has established clear methodologies for setting the regulated rate of return founded in economic and finance theory. To alter the method by placing weight on financial performance information (putting aside the difficulty of doing so) is incongruous with the incentive based framework. If the framework is designed to provide incentives for efficient behaviour, outperformance must be rewarded (and equally underperformance borne) to maximise benefits to customers over time, otherwise the regulatory return will need to be increased to better reflect the risk of investment in regulatory assets.

Adjustments to the rate of return must be based on the BEE and not individual circumstances of the business. Financial performance information (together with service performance information) is an indicator that the entire regulatory framework is working, not whether the rate of return meets the ARORO. To interpret the information to simply reflect the rate of return would make the ROR Guideline inconsistent with the way operating and capital expenditure allowances are determined, and financial incentive mechanisms are expected to operate, which seems counterintuitive.

2. **Should information on profitability, asset sales, financeability and any other financial information be used when assessing outcomes against the NEO and NGO, ARORO, and the related RPPs? If so, how?**

The AER's current approach of setting a rate of return based on the BEE, rather than actual financial information, is prudent and effective. As outlined in response to the previous question, the use of network specific information, particularly profitability and general financial information, to assess the regulated rate of return is a departure from the current methods for estimating efficient costs and undermines the incentives for delivering efficient outcomes for customers – valued services at efficient cost. Businesses that outperform would be penalised and customers would bear the burden of underperformance. Even if this information could be used to provide an industry wide view (affecting the BEE) rather than being calculated separately for individual business, the effect on incentives would remain and is of real concern. All businesses would be penalised for responding to incentives and customers would be penalised if the businesses do not.

Investors do not believe the AER should use information on profitability, asset sales, financeability and other financial information to assess outcomes against the ARORO. Whilst we are supportive of improving data quality where possible, using certain "ex-post" measures would have significant limitations in providing real insight as it is both inconsistent with the BEE as outlined above, and introduces the risk of further subjectivity and questions of data quality and comparability.

We agree with the AER's concerns about the use of financeability information and regulated asset base multiples outlined in the Issues Paper such as the difficulty of reconciling the information with benchmarks (gearing ratios and credit ratings), inconsistency between average market conditions and current market conditions, qualitative judgements, inability to isolate information from other elements of cash flows and comparability across NSPs and individual investor requirements. This information has many limitations in assessing performance of the NSP (as opposed to the consolidated entity) and in ensuring consistency and comparability across entities. For example:

- Profitability – the declared profit of an entity does not necessarily reflect the profit of the regulated ring-fenced NSP. Profit is impacted by the consolidated tax, depreciation and interest position of an entity and is a short-term concept that can be distorted by unexpected or one-off events as well as changes to Accounting Standards. The regulatory framework makes assumptions about tax and financing for a BEE rather than a consolidated entity, and regulatory depreciation is in no way related to statutory depreciation. Therefore, any attribution of tax, interest and depreciation expenses is of no value in assessing the performance of the NSP. There would also be additional costs incurred in establishing a framework and process for making the adjustments required to ensure information is comparable across NSPs with the final attribution of profit to an NSP more likely to be affected by how well the broader entity performed given the risk profile and broader environment. This information would provide no further additional insight than that provided in the current RINs.
- Asset sale values – the main concern with using asset sale value information is the inability to verify and scrutinise the information, long-term assumptions and various sensitivities and scenarios that may have been assessed and risk weighted. However, there are also many other limitations that distort the relevance of asset sale values as a standalone measure such as the relative contribution of unregulated cash flows, which is quite distinct for each business (e.g. connection opportunities in transmission vs. distribution networks, different regional characteristics and opportunities), tax savings and structuring arrangements. We also point out, that RAB multiples varying from 1.0x should be expected in an incentive

based regime where different businesses may perform better or worse than the benchmark. Asset sale value information cannot be relied on without:

- Verifying the information – a headline sale price is by itself not of any meaningful significance. The implied equity return is rarely able to be verified or scrutinised as it is based on numerous assumptions and forecasts that the acquirer rarely discloses. To rely on speculated returns from equity research houses or news sources, who are not privy to the actual business plan, would not be appropriate. It would also mean that the regulator relies on unsubstantiated information with less veracity than the information that the regulator currently has access to.
- Controlling for opportunities and risks unique to the purchaser and business – this measure is inherently circular as it reflects a view of the purchaser of the value of risks and opportunities, as well as unregulated cash flows which are often material depending on the network and its position. Data is generally not made available that would allow a third party to reliably estimate the split between the regulated and unregulated value in an overall business. Other opportunities and risks that may be taken in to account include the ability to reduce costs and outperform financial incentive mechanisms, prospects in merits and judicial review processes and upcoming regulatory determinations, opportunities to optimise tax across the entities, changes to the existing capital structure and views of inflation and broader economic cycles. The value of these opportunities and risks will also be affected by whether the purchaser will attain control and whether the sale is of a business moving out of government control for the first time or is a secondary sale. Each of these will be unique to the purchaser and the entity.
- Considering comparability – comparability of information will be affected by the sample size as well as timing and other external factors. There are more than 30 NSPs (21 electricity NSPs) regulated by the AER and from whom the AER collects detailed performance and operational data. Conversely, there have been very few sales in recent years; 3 government privatisations and 1 secondary sale. The sale value can be materially affected by a variety of factors at the time including broader investment market conditions and the prevailing policy and regulatory outlook.

- Financeability and other financial information – looking at financeability can be a useful exercise to assess whether the allowed revenue will enable an NSP to maintain the credit rating assumed in providing the overall rate of return. However, this assessment must be based on the deemed position of the NSP and not the actual position of the entity that owns the NSP or the consolidated entity. An ongoing assessment of the NSP may be affected by the revenue profile (smoothing) compared to the building block costs and the performance of the NSP against operating and capital cost forecasts. Financial information available for the owners of NSPs is only available for 2 listed Australian owners of networks – both with multiple networks and a combination of transmission and distribution and gas and electricity. Therefore, broker reports and equity raising analysis may not be representative of wider sector performance. Financial information available for government owned entities is limited and again contaminated by the larger entity (whole of government) positions rather than the position of the NSP. In any event credit metrics are heavily influenced by corporate financing and tax structuring which must be normalised for the BEE and broker assessments of Equity Risk Premium (ERP), Market Risk Premium (MRP) and equity beta are affected by the same issues as asset sale value information. Finally, financeability itself is a difficult concept to define, and may lead to a reduction in the certainty of outcomes.

Investors consider that adjusting determinations for individual NSPs based on financial information (from whichever source) is inconsistent with the AER's approach to setting the rate of return based on a benchmark. We support the AER's benchmark approach and agree with the AER that this provides incentives for NSPs to finance their business as efficiently as possible and reduce costs for the long-term benefits of consumers.

3. Is the current approach to setting the benchmark term and level of gearing appropriate?

The current approach to setting the benchmark term and level of gearing is appropriate and the current benchmark remains appropriate.

We support the AER's position that an efficient service provider of energy network services would use debt to finance 60 per cent of its capital, and would finance the remaining 40 per cent with equity. We also support the AER's assumption that an efficient NSP would issue debt with a 10-year term to maturity and estimate the return on equity based on a 10-year term to proxy the risk-free rate component of the allowed return on equity. We do not support re-considering the types of gearing measures that should be benchmarked (market or book values), nor do we consider that it is necessary to update empirical information for the benchmark term or level of gearing.

Investors see little value in re-setting the benchmark gearing. The current benchmark is long-standing, accepted and has been used as the base for capital management structures for NSPs for many years. A change in regulatory assumptions would entail consequential and expensive changes to capital management strategies which the end-consumer would ultimately bear. Further, assessing market information on benchmark gearing has become less relevant as the number of comparable firms is shrinking, gearing can vary considerably over time (and may reflect transition to an end state or market disruptions), or could be driven by a mismatch between required and regulated returns rather than the efficient level. In addition, information on the NSPs will include impacts of varying degrees of unregulated activities, tax and corporate structures which also influences total gearing and is often not specifically allocated (either from a security or ratings perspective) between the regulated and unregulated cash flows. Further, no useful or relevant information can be obtained from considering gearing in terms of book value as this value will almost never have an impact on the cost of financing debt or equity.

A change to the benchmark gearing should only occur where there are clear benefits to consumers over the longer term taking in to account all consequential changes to benchmark credit rating, term, market risk premium, equity beta and gamma.

4. Should the conditions and process for setting averaging periods be refined?

Investors support the AER's current process and approach for setting averaging periods and the prescribed conditions for choosing averaging periods. We consider that the conditions are sufficiently clear, and it is not necessary to be more prescriptive. NSPs are best placed to manage their capital risk and should retain discretion and flexibility to do so in a manner that minimises volatility. We do not support increasing the length of the averaging period as it would make it harder and impractical to implement effective hedges at an efficient cost. Second, we support retaining flexibility for NSPs to choose the start date for their averaging period to reduce execution risk and liquidity charges from bank swap providers that would be incurred if multiple NSPs undertake large hedge transactions on the same day (i.e. spreading the averaging periods will minimise the risk of adverse market movements which would ultimately add cost to the end-consumer). However, if the AER is minded to change the approach and process for establishing averaging periods, then any such change must be more fully tested against practical considerations.

Return on debt

5. To what extent are changes required to the current approach of transitioning from an on-the-day rate to a trailing average?

Investors are of the view that there should be no transition and there should be an immediate adoption of a trailing average methodology. The AER has acknowledged that a 10-year staggered portfolio of debt is an efficient debt strategy and that the BEE would manage its debt portfolio in this way. Therefore, there is no merit in adopting a transition which, by definition, prolongs an inefficient approach until some future date. This would not be in the long-term interests of consumers. Further, many networks already manage their debt portfolios in this more efficient manner and may be penalised by a transition. This reduces the incentives to adopt an efficient approach unless it exactly matches the regulatory assumptions – one of the reasons the AER sought to move away from the 'on the day' method.

We also do not support the AER's view that a transition should seek to be revenue neutral. NSPs have a right to an opportunity to recover efficient costs, including financing costs. A focus on revenue neutrality when it is the efficient costs, or assessment of efficiency costs, that is changing is inconsistent with this important principle under the National electricity and gas rule. A transition must consider the implications for recovering efficient costs and the incentives to deliver efficient outcomes both of which are required to promote the long-term interests of consumers.

6. **Is it appropriate for us to review the return on debt implementation approach by performing a review of the four third party debt data series currently available to us? Please also explain if you think there is further valuing in broadening this scope of debt implementation issues and why you hold this view?**

It is appropriate for the AER to review the third-party debt data series and form a view. The review should specify the debt series being referred to and the criteria for assessment. The data sets should be generated by a credible third-party source using a transparent methodology with a comparable data set that appropriately reflects the risks of the BEE. Where additional series are added, the weighting should be specified, and it follows that the extrapolation and interpolation be revisited.

Return on equity

7. **Would a more prescriptive approach to setting the equity risk premium be appropriate? If the Guideline has a more prescriptive approach to estimating equity risk premium, what set of conditions for reopening the Guideline would best achieve the national gas and electricity objectives and the allowed rate of return objective?**

As outlined earlier, investors seek to maximise investment certainty. We consider continuing the AER's current practice of adopting the foundation model approach utilising the Sharpe-Lintner capital asset pricing model (SLCAPM) will facilitate investor certainty.

Investors would only support a more prescriptive approach to setting the ERP to be appropriate if the ERP was set based on the foundational model approach utilising the SLCAPM and clearly understood methodologies for estimating the CAPM parameters. Consideration of estimates of ERP in surveys or broker reports would be a fundamental change to current regulatory practice and increase investor uncertainty. Such estimates are subjective, based on unknown methods and unpredictable.

If the approach to establishing the ERP was understood and accepted, providing a fixed ERP for the life of the ROR Guideline could provide certainty for investors. However, prevailing market conditions will impact on the ERP and if it is not adjusted accordingly, the rate of return may be too low or too high relative to the market. This could have a significant impact over the period of the ROR Guideline because of inefficiently high or inefficiently low levels of expenditure.

Whether a more prescriptive approach to setting the ERP is appropriate would depend on the approach, the methodology for estimation, the level at which it might be set relative to past and expected market conditions over the effective period, and the tolerances (if any) outside of which ERP might be reopened.

8. **Is the theory underlying the Black CAPM still appropriate for informing an equity beta point estimate? In its place, should alternative information to guide the selection of an equity beta point estimate?**

It remains appropriate for the Black CAPM to inform the equity beta estimate.

The Black CAPM was developed to correct a known systematic bias in the SLCAPM. The SLCAPM systematically underestimates the returns on low-beta stocks and over-estimates the returns on high-beta stocks. If the Black CAPM is no longer to be used in the AER's method for estimating the return on equity, then the application of the SLCAPM must also be re-considered and compared with other models and methods.

Regardless of the approach taken, qualitative adjustments will need to be made to the AER's estimated beta range because it is derived statistically from a small handful of domestic listed firms with investments in energy networks. These adjustments include evidence on overseas comparators, and academic evidence that the standard SL-CAPM tends to under-estimate required returns for low-beta stocks. These issues are expected to be exacerbated in empirical updates to equity beta.

The Investors would like to see further transparency and predictability in the AER's adjustments to the estimated beta range for evidence from overseas comparators and the Black CAPM evidence. Further, we seek clarity regarding the method for determining the range and point in the range for equity beta, when and how the estimate is to be updated during the term of the ROR Guideline term, and the characteristics of systematic risks considered to be incorporated in to the equity beta. We consider that there have been some material changes in the risks faced by NSP's since the Current ROR Guideline, so it will be important that the equity beta is updated to reflect the latest possible information at the time the ROR Guideline becomes effective to ensure that any contemporary systematic risks can be captured in the equity beta.

9. **What is the appropriate role of dividend growth models (DGMs) in setting the allowed return on equity?**

DGMs play an important role in establishing the market risk premium and return on equity because these models provide a forward-looking estimate and have strong predictive power. Investors have observed that, despite indicating that weight would be placed on DGM estimates in the Current ROR Guideline, the AER appears to have placed less weight on DGM estimates over time, despite these estimates continuing to rise after the AER increased its estimate of MRP to 6.5%. The AER has indicated that this is because of several limitations to the DGMs. The limitations identified by the AER are not new (they were debated around time the Current ROR Guideline was being developed) or universally agreed even by regulators, for example, IPART and the ERA continue to place weight on DGMs which has led to an MRP above 7%. These limitations, and the impact, should be investigated, so that the role and weight of DGM estimates can be clarified.

Investors encourage the AER to objectively and holistically review the conditions under which information is given weight and is impacted by other market factors. Further, investors encourage the AER to specify the method for determining the range and the point estimate, including how and when the estimates would expect to change in response to market conditions consistent with other regulators. Investors consider the market conditions have altered significantly since the Current ROR Guideline and the determination of the return on equity must be current and forward looking. Therefore, more rather than less weight should be placed on the latest forward looking DGM information and it should not be relegated to a cross-check.

Value of imputation credits

10. **Is it appropriate to limit the review of the valuation of imputation credits to updating the empirical analysis? Are there any particular issues we should take into account when updating empirical analysis?**

Investors consider that the approach to valuing imputation credits is yet to be satisfactorily settled. Investors acknowledge that various review bodies have supported the AER's extensive discretion regarding this issue. Nevertheless, there remains contention not only over the conceptual approach but also the approach to estimating the parameters and data to be used. The ROR Guideline process provides an opportunity to review the approach considering the material and decisions now available including the approach and reasoning of other regulators. For example, IPART interprets the value of gamma to be the market value of dividends and capital gains that investors would be willing to forgo in exchange for imputation credits and adopts a value of gamma of 0.25. Therefore, it is not appropriate to limit the review to updating the empirical analysis. Instead, the review should consider the method and data and clarify how the range and point estimate is to be determined.

Other components

11. **Should expected inflation and its interaction with the allowed rate of return be a priority under the ROR Guideline review?**

The AER considers a nominal vanilla Weighted Average Cost of Capital (WACC) will continue to achieve the NGO and NEO. However, we note that the AER has acknowledged that the compensation provided for the rate of return through the Post Tax Revenue Model (PTRM) and Roll Forward Model (RFM) provides for a real rate of return. We point out that there remains a mismatch between the AER's method for estimating the efficient cost of capital (which is determined in nominal terms) and compensation for the rate of return provided through the PTRM (which is determined in real terms). The AER (and its consultants) have acknowledged that this results in equity holders bearing the risk of the AER's forecast of expected inflation being inaccurate (forecast error risk) and that the impact could be substantial. It is not consistent with the NGO, NEO or the ARORO if this risk was not appropriately recognised in the rate of return. We disagree that this risk is currently compensated in the overall rate of return through the equity beta. This current review of the ROR Guideline provides an opportunity to ensure that this risk is appropriately compensated.

The AER is currently undertaking a review of the regulatory treatment of inflation and released a preliminary position paper. There are many issues to be resolved through this review, and the outcome is relevant to the rate of return. There is considerable contention over whether this risk is systematic and therefore incorporated in equity beta and, even if it was, whether the current estimates of equity beta consider the 2013 changes to the rate of return rules and the approach to estimating the efficient cost of debt. This risk was taken in to account by OFGEM in 2014 when it assessed the impact of prevailing conditions on the rate of return to apply to electricity network businesses. OFGEM provided an explicit additional allowance of 0.5% to recognise the risk and impact of low inflation when it determined that the rate of return should reduce by 0.3% rather than 0.8%.[2]

Therefore, the outcome of that review and the implications for the future rate of return must remain a priority under the ROR Guideline review.

[2] OFGEM, *Decision on our methodology for assessing the equity market return for the purpose of setting RIIPO-E1 price controls*, 17 February 2014, p. 12.