

16 January 2020

Mr Warwick Anderson
General Manager
Network Finance and Reporting
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Via email: rateofreturn@aer.gov.au

Dear Mr Anderson,

The Network Shareholders Group (**NSG**) participated in the AER's 2018 Rate of Return Instrument (**RORI**) process and welcomes the opportunity to contribute to the development of the process for the 2022 RORI.

We are generally supportive of the overall structure of the process undertaken for the 2018 RORI. However, we consider that there are several improvements that could be adopted to increase the confidence of stakeholders in the regulatory process and the outcomes, many of which address issues identified in the Brattle Report but not addressed in the changes proposed in the Consultation Paper, and are as follows:

- **Fairness** - The success of the RORI process must be measured by the confidence of all stakeholders that they will be heard; that their contributions and views could make a difference, and will be treated fairly and consistently;
- **Consistency** - We consider the early development of a transparent and objective framework for assessing the long-term impacts on consumers could aid the AER to demonstrate a consistent treatment of information and focus stakeholder contributions on material issues;
- **Objectivity** - We encourage the AER to take a stronger role in establishing agreed facts, identifying areas of agreement and disagreement and improving the rigor of explanations on material issues. This would be supported by incorporating opportunities to share and discuss early views to reduce surprises and test long term impacts;
- **Independence** - We encourage the AER to embrace the independent and expert views on its decision, including the merits of the decision, and explain differences in views and judgement. This will improve stakeholder confidence that evidence is assessed on its merits and aid transparency; and
- **Relevance** - We recommend that the regular updates should include an assessment of forecast methodologies and calculate the RORI parameters (including inflation) using the same method and approach adopted in the current RORI with the updated data.

If adopted, we believe our recommendations will aid transparency and provide stakeholders with more confidence in the independence and quality of the decision-making process as well as its outcome.

We look forward to working with you on the development of the 2022 RORI process and engaging in a meaningful way in the review itself.

If you have any questions or would like to discuss further, please contact Sally McMahon, Spark Infrastructure (phone 0421057821).

Regards,

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and Energy Policy
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ATTACHMENT: RESPONSE TO THE AER'S PATHWAY TO THE 2022 RORI CONSULTATION PAPER

1. Introduction and context

Electricity networks play a critical role in Australia's infrastructure and the transition to new energy systems as well as a low carbon future. As network investors, company Directors and energy sector professionals we have both an obligation and a key role in ensuring that the transition can occur fairly, efficiently and effectively. This includes:

- Implementing robust governance processes to ensure efficient investment in electricity infrastructure (both conventional network and digital non-network infrastructure) for the benefit of consumers and the Australian economy in general without compromising the reliability and security of electricity supply, and the safety of network employees and public; and
- Advising on the implications of changes to policy and regulatory frameworks that strengthen or weaken the investment environment, particularly in relation to the significant investment required to deliver a low-cost, low-emission energy system.

The NSG comprises Spark Infrastructure, HRL Morrison & Co, AMP Capital, AustralianSuper, IFM Investors, MIRA and CDPQ. Collectively, we hold significant investments in electricity transmission and distribution networks across NSW, South Australia and Victoria. The NSG has been established to strengthen the ability of our organisations to contribute to public policy processes.

The RORI affects the returns on more than \$90 billion in electricity network investment and is a key driver and determinant of efficient investment in network infrastructure over the long term. A reasonable return commensurate with risk supported by a robust, transparent and fair regulatory process for determining regulated returns promotes stakeholder confidence, which drives a lower cost of capital for the benefit of consumers.

In 2018, the RORI was elevated from a non-binding guideline to a subordinated legislative instrument resulting in a significant diminishment in investor and consumer protections, including:

- Significant reduction in judicial review grounds, in addition to the earlier removal of limited merits review;
- The removal of rules setting out fundamental regulatory principles, including the allowed rate of return objective and the concept of the benchmark efficient entity; and
- A significant expansion in regulatory discretion, guided only by the National Electricity and Gas Objectives and Revenue and Pricing Principles.

The 2018 RORI process resulted in the largest ever single reduction in regulated returns, comprising an 89 basis point reduction in equity risk premium, a 46% increase in the value of imputation credits to be deducted from returns, and a change to benchmark credit rating band from the BBB curve to a blend of BBB/A curves. This was despite the agreement by experts and market evidence that the risk of investment in regulated networks has not decreased.

In our view, this reduction in returns resulted in large part from a shift in focus towards short term price reductions, with less weight placed on longer-term impacts on price and service and, in doing so, leading to a break in fundamental investment principle that returns should be commensurate with risk.

In addition, the RORI passes through historically low interest rates into the regulated WACC indiscriminately, in contrast to observed market practice and lack of evidence that equity investors have reduced their hurdle rates as a result of the decrease in bond yields. Further, the AER's current approach to inflation does not appropriately account for low inflation, resulting in an even lower return on equity being determined than provided for in the RORI.

There is little recourse available to investors in the short term to respond to these anomalously low returns given the responsibility to maintain services, comply with obligations and ensure the safety of the community.

At the same time, there is a broader industry focus on ensuring that the national energy system is planned and delivered in a manner that ensures the right amount of investment occurs across the energy system; in the right place, in the right assets and technologies and at the right time to maximise savings to customers. This demonstrates a disparity between the capital required to undertake efficient investment and the capital available in competitive global markets at the regulated rate of return given the risk profile offered by the Australian market.

In this context, it would be prudent to consider the impacts of changes to the RORI on investment incentives, and the reasonableness of the overall return provided, rather than simply rely on mechanical estimation of individual parameters. The process should support this.

The robustness, transparency and fairness of the process by which the 2022 RORI is determined will be a critical factor in:

- Delivering an RORI outcome that best promotes the National Electricity and Gas Objectives by balancing the tension between capital requirement and availability;
- Ensuring investor confidence to support timely and efficient investment in networks and non-network digital infrastructure, including to build the interconnectors and modernise distribution networks into a platform for new energy technology and services; and
- Instilling stakeholder confidence by supporting the AER to deliver and take accountability for a decision that can be demonstrated to be independent, robust to challenge and free from bias.

As long-term investors in electricity networks, we consider we have a symbiotic relationship with consumers. It is in our interests to ensure that consumers receive the services they require now and in the future at the lowest possible price. As private investors, the businesses we invest in have and will continue to respond effectively to the strong incentives to achieve efficiencies and invest prudently whilst maintaining and improving services.

In order to support this, we encourage policy makers and regulators to maintain a stable and predictable regulatory regime that is underpinned by robust review processes. We also promote policy makers to keep a keen eye on the future so that current decisions do not result in significant increases in prices driven by higher required levels of investment, and higher required returns, necessary to address issues emerging that could be addressed today.

2. Recommendations

Our response to the Consultation Paper aims to assist in designing a process that supports the AER in executing its responsibilities and judgements in a way that provides stakeholders with confidence that they have been heard, that the information and views have been consistently treated and the judgement is defensible and delivers on the legislative requirements. This will in turn restore confidence to investors.

To achieve this, we recommend that the process incorporate the following:

1. **Establishment of an objective and transparent framework for assessing the long-term impacts on price, reliability and security of the energy system resulting from the RORI decision as well as agreed facts and relevant information in the initial stages of the review.**
 - This framework and information could be referenced by all stakeholders when submitting material and recommending a position or change in position, and by the AER when explaining its exercise of judgement.
 - The framework and information would include a series of indicators and measures that are relevant to assessing impacts on price, service and security (as required by the NEO and NGO), incentives for investment (as required by the Revenue and Pricing Principles in the NEL and NGL) as well as other factors that may be considered lead indicators for longer term impacts, such as the levels, trend and timeliness of investment, services and connections (load and generation), and progress on grid digitalisation. The relevant information should include forward looking information and an assessment of financeability that ensures internal consistency in assumptions and parameters.
 - This framework development process could, for example, set out:
 - Relevant facts and measures;
 - An assessment framework for how evidence and views will be assessed;
 - How the long-term impacts on customers and incentives for investment will be assessed;

- How the AER will engage at various process steps, for example, is a process step for sharing views or engaging, testing and investigating issues; and
- How the AER will achieve transparency and replicability as well as demonstrate independence and accountability.

2. Support overall process and timelines with some suggested improvements

- Concurrent evidence sessions – we support the continuation of the concurrent evidence session and opportunity for observers as well as the development of a joint expert report with the assistance of an independent facilitator. However, we consider the value of these sessions could be improved if an additional session was scheduled after the Draft Decision and experts are able to comment on how the AER has relied on opinions. Further, experts must commit to attend the sessions and participate in the development of the joint report.
- Independent review panel – we support the use of the Independent Panel but believe that integrity of the process, and confidence of stakeholders, can be significantly enhanced if: (i) the Panel's mandate includes a review of the merits of the AER's reasons and judgements; (ii) the AER explains its reasons for adopting or departing from the Independent Panel's views; and (iii) the Independent Panel is guided on key areas of agreement and disagreement among stakeholders and materiality of issues.
- Reference Groups – we support the continued use of Reference Groups, however their role and value-add to the process should be clearly defined. For example, the investor reference group became a forum for sharing process updates only and, when investor views were provided, it was unclear whether these were accepted as relevant evidence of investor behaviour (or discounted as anecdotal commentary). This group could be much more useful to the AER if it is used to identify and test evidence that facilitates understanding and implications on investment decisions and conditions. We recommend the following to assist the effectiveness of the group:
 - Clarify the group's role as assisting the AER to identify and test information and views regarding investor behaviour and markets;
 - Set clear eligibility requirements including a declaration of interest and a commitment to attend a minimum number of meetings and contribute to deliverables nominated by the AER Chair; and
 - Arrange facilitated meetings with other reference groups to share and seek to understand areas of agreement and disagreement.
- AER Board – we support opportunities for stakeholders to meet with the AER Board. However, we consider these opportunities would be more valuable if each group retains an equal opportunity to present and discuss issues.

3. Annual updates and working papers

- We support the AER's proposal of a foundational phase including annual updates and working papers. We recommend that stakeholders should have an opportunity to influence the topics covered, comment on draft papers and that final working papers remain open for challenge during the active phase. We also recommend that the annual update include a recalculation of parameters with the updated information adopting the same methodology and approach in the current RORI. Further, given the significant impact of inflation on the rate of return determined under the RORI, the updates should include inflation and an assessment of the forecast methodology.

4. Clarity and consistency in the AER's treatment of material provided by all stakeholders in forming its judgements

- The AER's role in the review should be clarified to be an active decision-maker. This should include:

- Clarifying the material that it considers ‘fact’ or ‘opinion’ and the weight given to the supporting material for an opinion;
 - Identifying areas of agreement and disagreement and the materiality of issues to be resolved;
 - Creating a safe environment for stakeholders to share and seek to identify areas of alignment and understand different points of view;
 - Develop its own positions with reference to the views and materials of stakeholders, share those positions in a timely manner to reduce surprises and seek further information where issues are relevant but insufficient evidence has been submitted;
 - Explaining the reasons for exercise of judgement, and how the material has led to the judgement;
 - Engage in an active dialogue with stakeholders and promote understanding of different views; and
 - Seek to identify and investigate why internal views differ to external views and explain the reasons for differences
- Prioritisation – stakeholders should be required to include in submissions a summary of priority issues, to assist the AER and Independent Panel in assessing relative materiality of stakeholder concerns
 - Material developed – the AER should be required to have regard to the material developed through the concurrent evidence and independent panel process, and although it should not be binding, the AER should be required to explain why it has accepted or discarded a majority or consensus view (and the information it has relied on in doing so).

3. Response to questions

Question	RESPONSE
<p>1. How could the CRG be adapted to improve their contribution to the review?</p> <p>2. Is there anything that needs to change about the CRG nomination process?</p> <p>3. What characteristics should be sought for CRG members?</p>	<ul style="list-style-type: none"> ● Same treatment for all Reference Groups <ul style="list-style-type: none"> ○ Include in the process pre-Scheduled joint meetings with other reference groups ○ Requirement to frame contributions and views in line with an assessment framework and agreed facts. ○ Equal access to AER staff and Board. ○ Require each member to state motivation for joining the group, including any constituents that they represent, that is available publicly.
<p>4. What should the CRG's main role be when in the 2022 process? Should the CRG's main role be to provide technical submissions or more customer focused submissions to the review process?</p>	<ul style="list-style-type: none"> ● The AER should assist in investigating views that might not fully appreciate the technical issues rather than dismiss views if the technical issues are not understood. ● Consumer views are valid regardless of understanding of technical issues therefore it is not appropriate to limit views to only consumers that have understanding of technical issues ● Could be supported by the CCP and AER to frame contributions around technical understanding and an assessment framework
<p>5. What scope is there for the CRG and CCP to work collaboratively to jointly contribute to the 2022 process?</p>	<ul style="list-style-type: none"> ● CCP could be a sounding board for views that may be better informed with technical understanding
<p>6. Does the AER's support of the CRG need to change ahead of the 2022 review? If so, how should that support change?</p>	<ul style="list-style-type: none"> ● Promote understanding of technical issues and statutory requirements of NEL, NER and Pricing Principles (for all reference groups).

Question	RESPONSE
<p>7. Do the IRG and RRG need to be altered to enable them to be able to more effectively contribute to the development of the Instrument? If so, what changes should be made to the groups?</p>	<p>The effectiveness of the group should be assessed against the objective of the group. We recommend the objective of this group be to assist the AER to identify and test information and views on investor behaviour and markets.</p> <ul style="list-style-type: none"> • Keep groups separate but organise scheduled joint meetings to discuss areas of agreement and disagreement. • Clarify the role and eligibility criteria. • Identification of deliverables and nature of evidence. • Support dialogue between the group and the AER, not just process updates. • Active participation a condition of membership. • Requirement to frame contributions and views in line with an assessment framework and agreed facts.
<p>8. How could the concurrent evidence sessions be adapted to improve discussion on topics?</p>	<ul style="list-style-type: none"> • Commitment by AER to respond to material with an explanation of how the views have been considered in its judgement and why the views have been supported or not. • Enable facilitated discussion between AER and experts • Experts able to comment on the way the AER has relied on opinions • The AER commit to take on board the agreed views; not be bound but expected to explain why it has not adopted the agreed view rather than dismissing the views for process reasons. • The challenge with increasing the number of sessions will be resource availability – human and financial. These sessions should not have the effect of spreading experts thin or reduce the ability to focus and improve the quality of the sessions.
<p>9. At what points in the process would the concurrent evidence sessions aid the most?</p>	<ul style="list-style-type: none"> • Prior to, and after, the Draft Decision and before the Independent Panel reviews the Draft Decision

Question	RESPONSE
<p>10. What could be done to better assist the concurrent evidence sessions to fulfil their role? Do the evidence sessions need to be extended to allow more discussion on certain topics or should the number of rounds be increased?</p>	<ul style="list-style-type: none"> • Experts should be provided for the entirety of each session, and be able to discuss and be questioned on any issue in their area of expertise • Allow attendance by observers • Scheduled in advance and require a commitment for experts to attend and participate in the development of a joint report. • An additional session to take place after the Draft Decision.
<p>11. Do stakeholders consider the Joint Expert Report was useful to the process? How could it be improved?</p>	<ul style="list-style-type: none"> • Yes. The concurrent evidence sessions should result in a report (as occurred in 2018) which clearly sets out points of agreement or consensus on issues • The AER should commit to respond to the report and explain how it has impacted on its judgement.
<p>12. Are there any adjustments that could be made to the Independent Panel that would assist it in undertaking its role?</p>	<ul style="list-style-type: none"> • Support the continued use of the Independent Panel to promote confidence that findings are supported by sound reasoning based on available information. • Should be considered by the AER as facilitating a quality decision and reasons. • Include consideration of the merits of the judgement and reasons in the scope • Should occur after the second concurrent evidence sessions, and have scope to include consideration of merit with views not binding (AER must provide reasons) • Stakeholders should include in their submissions a summary of material issues that can be provided to the independent panel to guide the consideration of issues.