



2 July 2021

Mr Warwick Anderson  
General Manager, Network Finance and Reporting  
Australian Energy Regulator

By email: [RateofReturn@aer.gov.au](mailto:RateofReturn@aer.gov.au)

Dear Mr Anderson,

### Re: Response to AER RORI 2022 working papers

The Network Shareholders Group welcomes the opportunity to comment on working papers issued recently by the Australian Energy Regulator (AER) setting out its current position and relevant issues to be considered in developing the 2022 Rate of Return Instrument (2022 RORI).

The NSG comprises a mix of Australian and foreign investors namely AMP Capital, Australian Super, CDPQ, HRL Morrison & Co, IFM Investors, Macquarie Infrastructure and Real Assets, OMERS, and Spark Infrastructure. We are global investors in infrastructure and other asset classes with equity infrastructure investments close to AU\$300 billion. Our infrastructure investments include Australian electricity and gas transmission and distribution networks in New South Wales (NSW), South Australia (SA) and Victoria.

We play a critical role in informing public policy and regulatory processes for Australia's future infrastructure investments. We carefully consider conditions in financial capital markets to ensure that government infrastructure and policy commitments deliver the desired improvements to the lives of all Australians.

In this submission, we provide perspectives from the market on the approach the AER is taking to estimating the efficient market return and assessing the long term interests of consumers. As providers of capital required to support the energy transition and deliver lower cost electricity services to consumers, our experience with estimating the cost of and attracting capital is highly relevant to achieving the National Electricity Objective (NEO) and the National Gas Objective (NGO).

As network investors we are seeking stability, transparency, consistency and predictability over time. We make significant investments in long life infrastructure that span more than one regulatory period or RORI term. Change in the RORI without adequate reasoning or evidence increases investment risk and therefore equity holders' expected returns, particularly in a situation where effective recourse over regulatory decisions does not exist.

Our detailed comments in response to the AER's working papers are attached. In addition, we make the following high level comments and observations:

1. **The AER's process and approach must be unbiased** – we are concerned that the issues and approaches being considered by the AER in its various papers favour a reduction in the rate of return because of methodological changes rather than because of changes in the efficient cost of capital. The AER also appears to be seeking precision on individual issues rather than focusing on relationships between parameters and overall outcomes.
2. **Regulatory stability and predictability are essential for encouraging investment** – the AER appears to be revisiting the fundamental approach to setting various parameters that have been in place for many years and reconfirmed in consecutive reviews. This includes the term used to set the return on debt and return on equity. For the market, this is destabilising and not conducive to establishing a sound regulatory environment to attract capital. With an established track record of more than 20 years' of setting the rate of return, the need for ongoing change should be minimal and reflect evolving changes in the efficient return required by investors.
3. **The long term nature of investment decision making needs to be considered** – there is merit in addressing the uncertainty and volatility between and across regulatory periods that is apparent in the

AER's current approach to determining the cost of equity. The RORI settings applied now will underpin energy infrastructure investments that will last the next 40-50 years. The long term interests of consumers will only be achieved if today's investment decisions relating to long term infrastructure assets are appropriate.

4. **Market evidence, experience and expertise are relevant to the task** – it is critical that the AER gives weight to actual practice of equity analysts, valuation experts and views of equity investors in fulfilling its task of estimating the efficient cost of equity. Relying on a theoretical approach that does not attract actual capital is not in the long term interests of consumers. The AER should not dismiss or discount market information and practice in assessing whether its estimate is indeed the best impartial estimate of an efficient market return on equity.
5. **Impacts and outcomes need to be measured** – the AER is yet to establish how it will assess and demonstrate that its estimate of the efficient cost of capital is consistent with the Law and the NEO/NGO. This includes how its estimate impacts on incentives for investment and the long term interests of consumers and can be done by the AER demonstrating that its estimate is the best unbiased estimate and does not introduce unnecessary risk or create unintended consequences such as deteriorating financeability of investments.
6. **Transparency of the regulator's decision and process are paramount** – as an effective review process is not in place, the AER would benefit from additional steps to increase transparency and accountability rather than current plans to remove established processes that improve these outcomes. Transparency examples include retaining the joint expert report and ensuring the Independent Panel is tasked and resourced to provide maximum confidence in relation to the AER's approach.

The AER's current approach is introducing unnecessary additional risk and uncertainty to the market. This will not ultimately be conducive to investment and put the long term interest of consumers at risk. We look forward to the AER addressing these issues in its review.

We will separately provide the AER with nominations for the conclave and concurrent evidence sessions and Independent Panel to ensure that there is institutional expertise to support the assessment of the cost of equity.

**Rick Francis**  
Managing Director  
Spark Infrastructure

**Christopher Curtain**  
Managing Director, Australia  
OMERS Infrastructure

**Jean-Etienne Leroux**  
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**Nik Kemp**  
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**Michael Hanna**  
Head of Infrastructure – Australia  
IFM Investors

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**Kieran Zubrinich**  
Head of Macquarie Australian Infrastructure Trust  
Macquarie Infrastructure and Real Assets

**Steven Fitzgerald**  
Head of Asset Management  
HRL Morrison & Co

## ATTACHMENT A: RESPONSE TO THE AER'S PAPERS

Noting the high level comments in our cover letter, this attachment sets out our more detailed comments on the views and issues expressed by the AER in its papers released in May and June 2021 related to:

- Assessing the long term interests of consumers, Position Paper
- Term of the rate of return, Draft Working Paper
- Rate of return and cashflows in a low interest rate environment, Draft Working Paper
- Consultation Paper on 2022 Instrument Process.

Before turning to our comments on the AER's papers, we present evidence around the impact that the current rate of return settings on investment in energy infrastructure have had in Australia. We are concerned that the current RORI and the issues that the AER has signalled for consideration as part of the 2022 RORI process will result in the rate of return remaining too low to attract the necessary investment to support Australia's energy future.

### Assessing the long term interests of consumers

#### Key messages

- We support the principle that the AER should be seeking to estimate the expected efficient return consistent with the relevant risks involved in providing regulated network services.
  - Accepting this principle relies on the AER demonstrating how it will assure that the estimate is the best unbiased estimate.
  - The AER must undertake a transparent assessment of the impact of the estimate, and change in the estimate, on incentives for investment, the opportunity to recover efficient costs and the long term interests of consumers.
  - The AER's assessment cannot exclude relevant market practice and outcomes if it is to demonstrate that the estimate is commensurate with risk and will attract capital. It is not enough to rely on theory that has not been tested in practice.
- The AER should consider additional principles to build confidence in the regulatory process and decisions such as consistency, stability, transparency, predictability and demonstrating accountability and independence.

### Providing the right incentives for efficient investment in the future

The national electricity and gas regimes establish a clear objective that the AER must demonstrate it has considered. In each case, the objective is to promote efficient investment in, and the efficient operation and use of, the relevant electricity and gas services, for the long term interests of consumers with respect to the price, quality, safety, reliability and security of supply.

The AER has consistently recognised the need to identify that the best possible estimate of the expected rate of return is one that is neither too high or too low, as this will promote efficient investment in, and the efficient operation and use of, energy network services. It also correctly identifies that it is consumers that will ultimately bear the cost of the regulator getting the rate of return estimate wrong.<sup>1</sup>

The RORI must ensure that the rate of return estimate promotes efficient investment in energy services. To date the AER's focus appears to have been dominated by the need to avoid the risk of over investment

<sup>1</sup> AER, Assessing the long term interests of consumers, Position Paper, May 2021, pp.8-9.

in energy networks. However, we believe that the AER has paid insufficient attention to the risk of under investment in energy networks caused by a rate of return that is too low.

As investors in long lived infrastructure assets, we are concerned that the AER is focusing on short term price reductions at the expense of long term energy transition and grid stability which is critical to achieving the long term interests of consumers. There is a significant risk that if the AER continues to adopt this approach the rate of return will remain too low to attract the necessary investment required to support the ongoing needs of Australia's transitioning energy system. This would compromise not only the infrastructure investment plans of governments across Australia, but also the benefits to consumers in terms of price, quality, safety, reliability and security of energy supply.

There is already considerable evidence to suggest that the rate of return set in the 2018 RORI, which reduced the equity risk premium by 95 basis points, was too low to attract the necessary investment:

- Australia was recently ranked in the third quartile for relative attractiveness of investing in regulated networks<sup>2</sup>
- Australia was ranked second lowest at 1.6% on the allowed pre-tax WACC (adjusted for inflation and government bond yields to account for sovereign risk)<sup>3</sup>
- The AER's own advisors, the Brattle Group, have highlighted that the AER's 'outlier' approach led to an equity return lower than seven other regulators in UK, US, NZ, Italy, and the Netherlands.<sup>4</sup>

The rate of return drives investor decisions about whether to provide and allocate capital to support network investment proposals. As a result, underinvestment in prudent and efficient capital projects only occurs where the rate of return is less than the return required by investors (too low). If the return is higher than the return required by investors (too high), investors remain unlikely to spend more than the allowance because they are penalised under the financial incentive scheme if they do so even if the investment is efficient.

A further concern is the demonstrable evidence that investment in electricity networks is falling and the correlation between this investment trajectory and falls in regulated returns.

Figures 1 and 2 from the AER's State of the Energy Market Report show the significant reduction in investment that has occurred between 2011 and 2019.

The failure of the regulatory framework to provide efficient risk adjusted returns has meant that some large-scale infrastructure investments have required government intervention in the form of underwriting and financing support. The funding provided by the Clean Energy Finance Corporation (CEFC) to finance Project Energy Connect (PEC) is a case in point (discussed further below). There is a risk that investment in networks will fall even further over the next few years if equity returns are not restored to be consistent with market requirements, in the absence of government continuing to step in to support those investments.

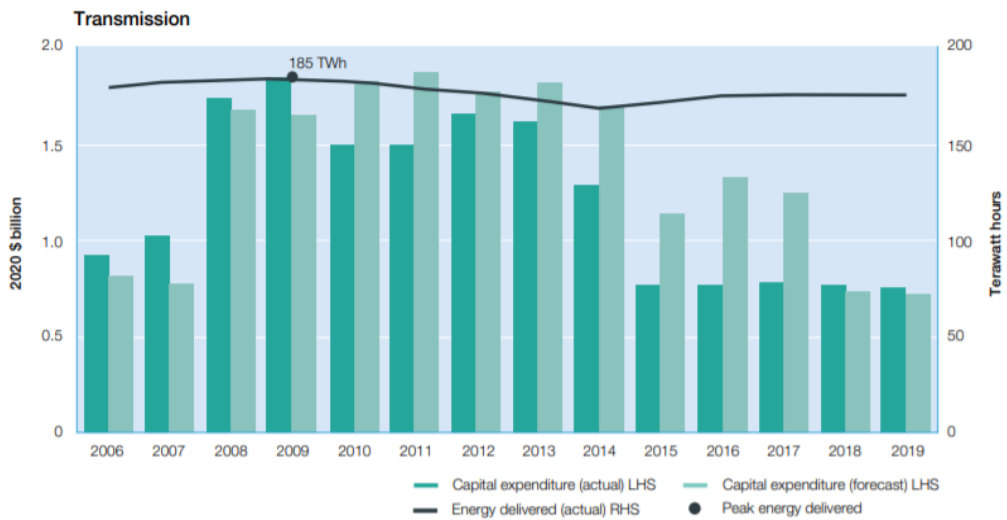
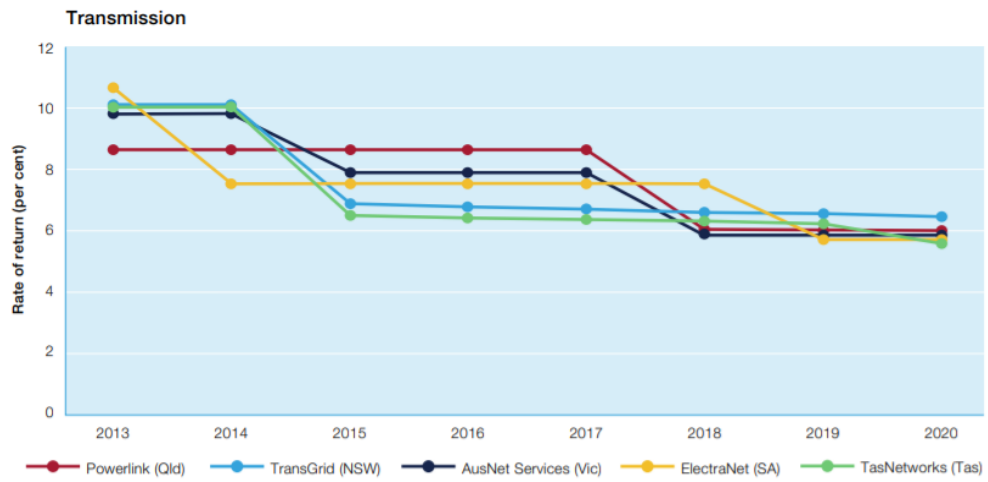
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<sup>2</sup> Morgan Stanley, Utilities Global Lens: Where to invest in regulated utilities amidst global macro environment, April 2021, p.3.

<sup>3</sup> *ibid*, p.11.

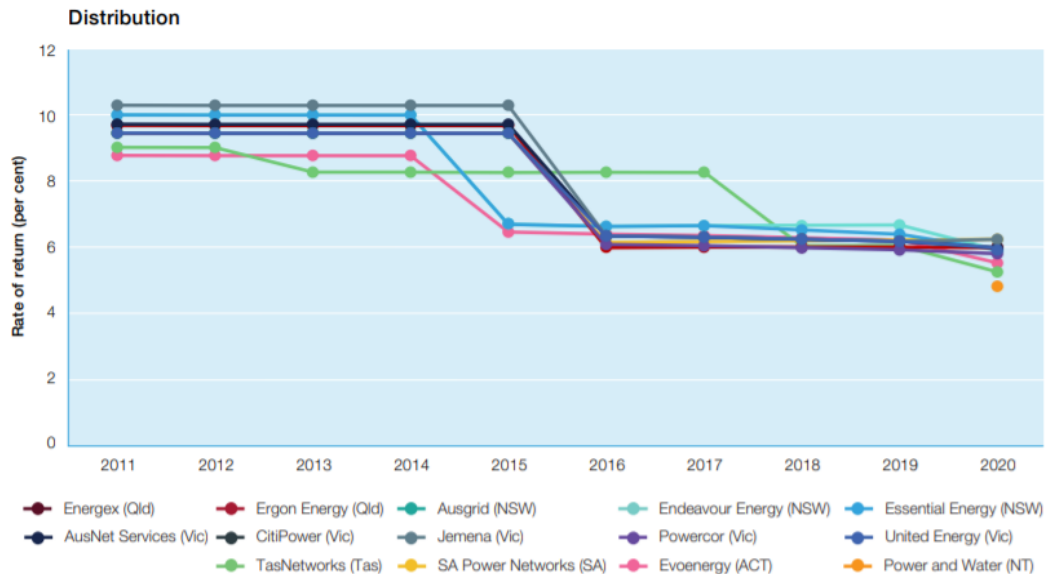
<sup>4</sup> The Brattle Group, International approaches to regulated rates of return, September 2020, p.11.

Figure 1: Rate of return vs investment in energy networks - transmission

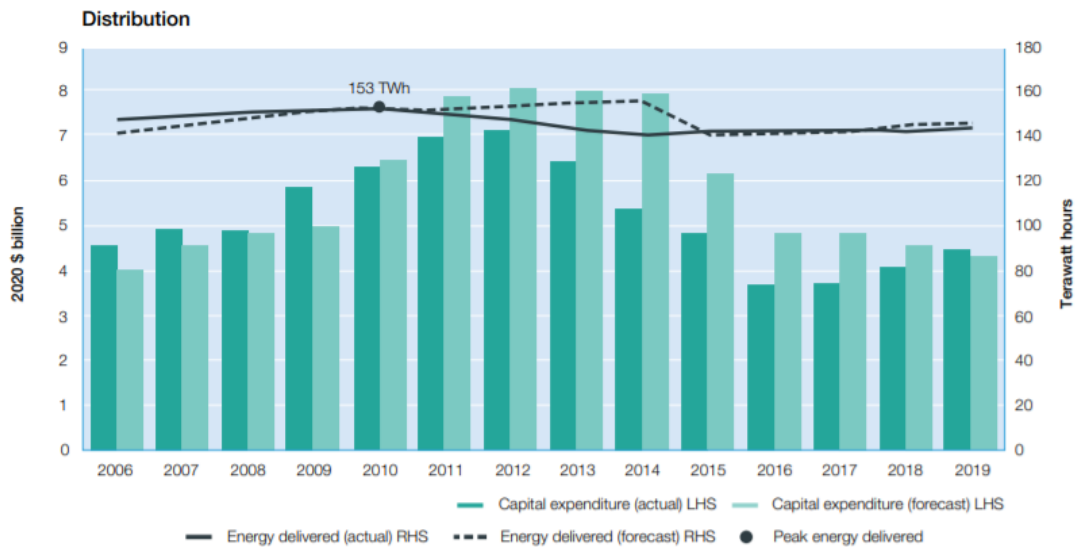


Source: AER, State of the Energy Market Report, July 2020, p.148 and 156.

Figure 2: Rate of return vs investment in energy networks - distribution



Note: Rate of return is the nominal vanilla weighted average cost of capital (WACC).  
 Source: AER decisions on electricity network revenue proposals; AER decisions following remittals by the Australian Competition Tribunal or Full Federal Court.



Source: AER, State of the energy market report, July 2020, p.148 and 156.

We accept that regulated returns are not the only factor influencing investment. However, it is difficult to explain why investment has remained below the efficient allowance provided by the regulator if returns have been sufficient.

In its 2018 report for the Network Shareholders Group, HoustonKemp found that historical outcomes show a statistically significant, positive relationship between the equity risk premium (ERP) signaled by the regulator and the ratio of actual-to-allowed (forecast) capital expenditure. This means that a reduction in signaled ERP can be expected to reduce capital expenditure relative to the efficient capex allowance determined by the regulator.<sup>5</sup> HoustonKemp concluded:

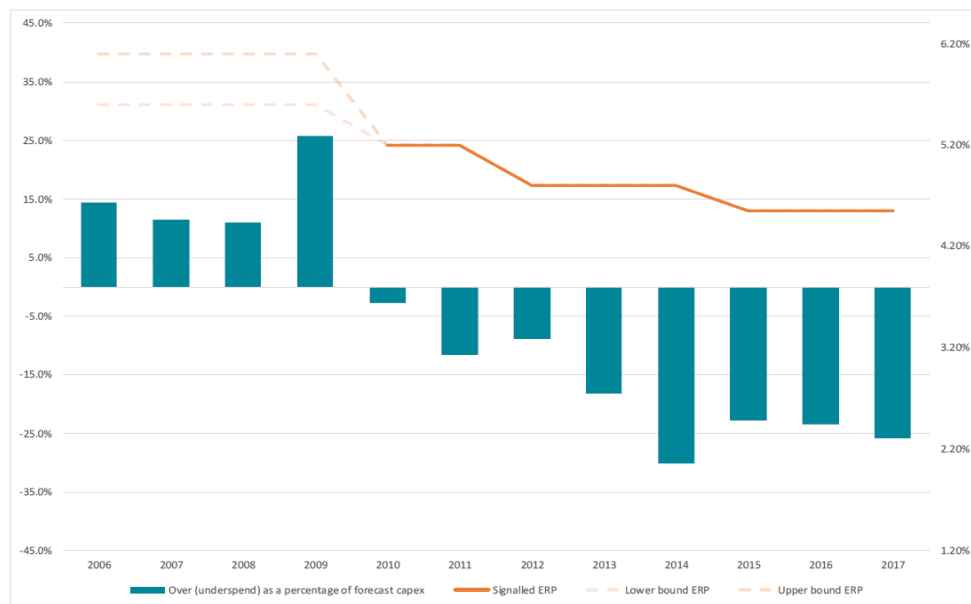
<sup>5</sup> HoustonKemp, The impact on investment of lowering the equity risk premium – an empirical assessment, December 2018, p.1.



Our analysis highlights the real risk to future investments associated with a reduction in the future ERP and the effective return on equity more broadly. In an environment in which the energy sector is acknowledged to be transforming and in which additional capital expenditure to facilitate the least cost transition is widely anticipated to be accepted by the AER and reflected in future capex allowances, the proposed reduction to equity returns may not be in the long term interests of consumers making it inconsistent with the NEO/NGO.<sup>6</sup>

Figure 3 demonstrates the variation between the efficient capital expenditure allowance supported by the AER and the capital expenditure incurred. This gap must be understood.

**Figure 3: Actual capex over (under) spend as a percentage of forecast capex and the signalled ERP – all electricity networks**



Source: HoustonKemp, *The impact on investment of lowering the Equity Risk Premium – an empirical assessment*, December 2018.

The relationship between returns and investment cannot be overlooked and is critical to the investment required to support Australia’s energy transition. The Energy Security Board determined that the outlook for efficient and timely investment in networks remained ‘moderate’ due to emerging challenges in achieving timely construction of transmission network expansion required to connect renewable generation, and the significant distribution network investment needed to support distributed energy resources such as rooftop solar to integrate further into the system. It also recognised that inefficient network investment will unnecessarily increase customer costs.<sup>7</sup> The AER should at a minimum seek to understand the relationship between returns and investment to ensure that its decisions are in the long term interests of consumers.

The Network Shareholders Group is concerned that the AER’s working papers imply that it may be contemplating further reductions in the 2022 RORI based on selective changes to the determination of various parameters. As investors operating in international financial markets, we caution that any further reduction in the rate of return is likely to further reduce investors’ willingness to deploy capital to the Australian energy market in a timely and sustained manner, and to shift the focus and attention of investors to opportunities in other sectors and offshore.

<sup>6</sup> ibid, p.7.

<sup>7</sup> Energy Security Board, *The Health of the National Electricity Market*, Volume 1, 2020, p.43.

All investment, including major projects should be financeable under the RORI if returns are commensurate with risk

A rate of return that is set too low has the potential to put Australian governments' energy transition plans at serious risk including the need for continued investment to support more renewables entering the energy system, while also maintaining reliability and affordability. Economic efficiency needs to have regard to the long term impact that efficient network investment will have on facilitating more renewables in the system and cheaper wholesale energy prices. Without network investment, consumers will not realise the savings achieved over the long run from proven wholesale electricity cost reduction.

The risk of setting the rate of return too low is particularly acute for large projects such as interconnectors. These are multi-billion-dollar projects and often involve a higher construction risk than regular ongoing capital investment. For this reason, it is standard market practice globally to consider an additional risk premium for these types of large greenfield projects.

As an example, PEC is a critical piece of national energy transmission infrastructure and part of the NSW Government's Infrastructure Roadmap that will assist Australia to meet its climate change targets, drive competition in the whole electricity market, enhance grid stability and reliability.<sup>8</sup>

The large scale greenfields nature of this project has exposed fundamental flaws in the regulatory framework's ability to support the private sector investment required to support critical new transmission infrastructure to unlock further renewable generation. TransGrid and its securityholders had to work through several complex issues associated with financing such a large greenfield project in a low return environment.

Ultimately, the funding for PEC included a A\$295 million, hybrid security instrument in the form of subordinated notes from CEFC. The hybrid security instrument will form part of TransGrid's ongoing capital structure and attracts partial equity credit treatment from Moody's. Without CEFC support, PEC would have been unable to proceed. In analysis undertaken for the Australian Energy Market Commission, CEPA found that a regulated transmission network service provider undertaking a project of similar magnitude as PEC would not achieve a key threshold (Funds From Operations/Net Debt) to achieve or maintain a credit rating consistent with the credit rating the AER uses to estimate the cost of capital.<sup>9</sup> Indeed, the transmission network service provider would have to alter its gearing to retain its rating, reducing the return to equity holders below the return on equity set out in the RORI. This internal inconsistency remains unexplained. The problem is not accessing capital, the problem is attracting capital for the return provided when that return is insufficient for the credit rating and gearing required.

There are limits to the extent to which hybrid funding with green banks such as CEFC can support Australia's transitional energy needs going forward as this form of funding can quickly become limited and can cause concentration issues. CEFC's Grid Reliability Fund is limited to \$1 billion and is not restricted to large grid/interconnector augmentations – it is also expected to be used to support storage projects, grid stabilising technologies and other innovative solutions. Ultimately, the regulatory system should deliver outcomes that do not require ongoing government support.

### Assessing the long term interests of consumers

The AER has released a position paper setting out its views about what the NEO and NGO mean in the context of setting the expected rate of return and how the concept features in setting the expected rate of return. It presents its guiding principle that the rate of return should provide:

<sup>8</sup> PEC is a new 900km high-capacity electricity interconnector between Robertstown SA and Wagga Wagga NSW, including short spur from Buronga NSW to Red Cliffs northwest Victoria.

<sup>9</sup> CEPA, Financeability of ISP Projects, Report undertaken for the AEMC, 27 January 2021, p.26.



*an unbiased estimate of the expected efficient return, consistent with the relevant risks involved in providing regulated network services.<sup>10</sup>*

We note also the AER's recognition that:

*Setting the expected rate of return is not a precise science and involves uncertainty and judgement. Due to inevitable uncertainty, there is a risk that the estimated expected rate of return will be higher or lower than the actual market cost of capital. If the expected rate of return deviates from the market cost of capital then it may not promote efficient investment in, and use of, the service provider's energy network in the long term interests of consumers. ... While the capital market transaction is between investors and networks/pipelines, the ultimate effects will flow through to the prices the consumers pay and the services they receive.<sup>11</sup>*

We support the principle of seeking the best unbiased estimate of the expected efficient return consistent with the relevant risks involved in providing regulated network services, and the emphasis on several key aspects of the principle including that:

- an unbiased estimate of expected efficient returns consistent with relevant risks will drive outcomes that are in the long term interests of consumers
- returns that are too high will drive over investment in energy networks, and conversely returns that are too low will worsen long term outcomes for consumers as a result of under-investment in energy networks
- the focus should clearly be on assessing the long term implications of the estimate since investment decisions are made today for the future, and there is a tendency for consumers and others to focus on short term more measurable impacts.

In its position paper, the AER has been upfront about the intergenerational wealth transfer resulting from the long term focus at the expense of current taxpayers/consumers. The intergenerational wealth transfer issue is not in itself a sufficient argument since:

- it is a clear contradiction with the NEO which promotes efficient investment in electricity services for the long term interests of consumers
- it may increase the long term cost for consumers if necessary investments are delayed.

The AER has not clearly articulated how it will ensure that its estimate represents an unbiased estimate of expected efficient returns consistent with the risks involved. While it recognises that the rate of return estimate is an imprecise science and involves uncertainty and judgement, it does not set out how it will assure itself that the estimate it derives is the best possible estimate and minimises the adverse risks imposed on consumers from over or under investment.

In the absence of understanding how the estimate will be assessed as best and unbiased, the AER's guiding principle has little value. Further, it is unclear what market information will be relied on, how information from experts will be weighed or how impacts on incentives for investment and the price, service, reliability, and system security in the long term interests of consumers are to be assessed.

We note the observations of the Independent Panel established to review the Draft RORI in 2018:

*While the [AER] addresses each technical step in the rate of return calculation, it does not sufficiently consider or demonstrate how each of the decisions about individual parameters, when taken together to produce a final estimate of the rate*

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<sup>10</sup> AER, Assessing the long term interests of consumers, Position Paper, May 2021, p.1.

<sup>11</sup> *ibid.*, p.2.

*of return and value of imputation credits, will contribute to the achievement of the national gas and electricity objectives.*

*The AER should explain more clearly how the Final Guidelines promote the achievement of the national gas and electricity objectives, **including why the AER is confident that the rate of return methodology that it has determined results in an outcome that is neither too high or too low.**<sup>12</sup>[emphasis added]*

In 2020, the Australian National Audit Office (ANAO) also found that the AER's performance reporting arrangements have not enabled it to demonstrate that it is meeting its purposes, such as promoting the efficient operation of energy services for the long term interests of energy consumers with respect to price, quality, reliability and security:<sup>13</sup>

*Reliability, quality and safety elements of the AER's purpose are not explicitly covered in performance indicators, and there is limited consideration of security and price particularly with respect to the long term interests of consumers... Efficient investment is another element of the purpose that is not reflected in the performance indicators.<sup>14</sup>*

These comments echo our sentiments that the AER needs to pay greater attention to the overall rate of return outcome, and its impact on efficient investment and the long term interests of consumers.

We believe the AER should be more explicit about how it will transparently assess:

- whether or not the estimate is the best possible estimate – for example, does the AER propose to compare its estimate to other relevant benchmarks including market estimates, analyst estimates or valuation expert estimates in the energy market and other markets where the risks are commensurate?
- the impact of its estimate on incentives, efficient utilisation and use, and the long term impacts on services and prices – for example, does the AER consider the regulated return has an impact on investment (and therefore services and prices)? If so, how will that be assessed? If the AER assesses the 'sufficiency of returns' as it did in the performance report, will it genuinely consult on the method that it uses to ensure it relies on relevant information and tests relevant assumptions and opinions?
- the risk/reward proposition – for example, if the return on equity is to include compensation for systemic risk, how will the methodology enable changes in risk to influence the return on equity? Also, will it use comparisons of returns and risk with other regulated energy networks?
- whether or not the estimate is unbiased – for example, bias could be contained in the assessment of views and evidence (applying a higher/lower threshold of evidence to information and views that reduce/increase the estimate), the issues investigated (have all issues been investigated regardless of whether they might increase/decrease the estimate), and in applying the AER's judgement and discretion?

We welcome the AER's further guidance as to how it will address each of these matters to demonstrate that its final rate of return estimate is consistent with the NEO and NGO objectives.

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<sup>12</sup> Independent Panel, Review of the Australian Energy Regulator's rate of return draft guidelines, 7 September 2018, p.iv and v.

<sup>13</sup> ANAO, Regulation of the national energy market, 3 September 2020, p.7.

<sup>14</sup> *ibid*, p.44.

## Term of the rate of return

### Key messages

- An appropriate term for estimating the return on debt and equity has not changed since the 2018 RORI and remains at 10-years.
- The term used for forecasting inflation should be the five-year regulatory period.
- There has been no change in the theory or practice to warrant a change in the term used for debt and equity, and evidence and practice support a 10-year term or longer.

The AER's working paper seeks to reconsider the issue of what is a suitable term for setting an efficient rate of return and whether the terms for return on equity, return on debt and expected inflation should align. Our comments focus on two key questions:

- whether the term for setting an efficient rate of return should move away from 10 years and align with the term of the regulatory period (five years)
- whether the term of expected inflation should match the term for the rate of return.

On the first issue, we note that the AER has consistently adopted a 10-year term when setting both the return on equity and return on debt and rejected shorter terms. The AER's 2018 RORI decision to maintain use of a 10-year term was originally based on its view that this was consistent with:

- the theory of the Sharpe-Lintner Capital Asset Pricing Model (SLCAPM) which is a single period equilibrium model, estimating the returns an investor requires over a long term investment horizon
- other return on equity parameter estimates, particularly the market risk premium
- extensive evidence of actual investor valuation practices and academic works
- its decision in the 2013 guidelines and regulatory determinations since then.

The AER's working paper recognises the reasons for retaining a 10-year term including the fact that it better matches the long-lived nature of the underlying assets, the general market practice of financial practitioners is to use a 10-year term, other regulators have often adopted a term of equity that is longer than the length of the regulatory period and maintaining a 10-year term would promote regulatory stability and predictability.<sup>15</sup>

We do not support a change in the approach from setting the rate of return based on a 10-year term for both debt and equity. There is no clear basis for moving away from a 10-year term towards a shorter term aligned to the length of the regulatory period unless the objective is to put further downward pressure on regulatory returns. In particular:

- **The relevant NPV period for estimating equity returns is the life of the investment rather than the five-year regulatory period** – Investors in long term infrastructure assets expect to retain that investment for a long term. Most Australian airports/ports and have not changed hands since privatization and privatised energy distribution and transmission assets have been retained almost entirely by initial owners. It is appropriate that the term used for debt reflects the efficient practice of debt financing – that is, a longer-term portfolio of debt. The AER's advisors on the application of the SLCAPM also consider matching the term to the maturity of the investment.<sup>16</sup>
- **Market, analysts and valuation experts all use a term longer than five years for both debt and equity** – There is no evidence to suggest that equity investors adopt a shorter term when

<sup>15</sup> AER, Term of the rate of return, Draft working paper, May 2021, p.5.

<sup>16</sup> Partington and Satchwell, Report to the AER: Alternative Pricing Models, 30 June 2020, p. 21.

estimating the cost of equity for long life energy network investments. Market, analysts and valuation experts all typically use a longer term.

- **Regulators around the world typically use a 10-year term** – As noted by the AER, the reasons typically afforded by domestic regulators for adopting a 10-year term for both the return on debt and the return on equity are to provide a reasonable proxy using available data in the market, and to promote investment.<sup>17</sup> The only exceptions that we are aware of are the Economic Regulatory Authority of Western Authority (ERA) and the New Zealand Commerce Commission. We note that the AER has previously rejected other methodologies adopted by the ERA when they have had the effect of increasing the rate of return, such as breakeven inflation and an equity beta of 0.7. The operation of these elements together affects the overall expected return and should not be considered in isolation.

We note the AER's argument that 'the yield curve is typically upward sloping which means a longer-term risk free rate will lead to higher regulatory cash flows than if a shorter-term rate is used'.<sup>18</sup> However, this would appear to be inconsistent when the AER's position expressed in other papers showing that rates have consistently reduced since the early 1990s and are now at historical lows.

The AER risks creating a biased estimate of the rate of return by reopening this argument at a time in the cycle when the difference between a five and 10-year term is at its greatest and is therefore likely to have the greatest downward impact on the rate of return estimate. Overall, our view is that the AER should continue to adopt a 10-year term when setting both the return on equity and return on debt. This is both justifiable and consistent with maintaining stability and confidence in the regulatory regime.

In relation to the second key question, we do not consider that the terms for return on equity, return on debt and expected inflation should be aligned. The objective of the inflation forecast is to ensure that the value of the Regulatory Asset Base (RAB) that is taken out matches the value of the RAB that is put back in at the end of the period. The term for forecasting inflation is independent of the term used for estimating returns on debt and equity.

## Rate of return and cashflows in a low interest rate environment

### Key messages

- There is merit in investigating options to reduce volatility and exclude the impact of anomalous market conditions.
- Changes in methodology should only occur where they better reflect cost and not occur in a biased manner.
- It is inappropriate to consider each parameter independently of relationships and outcomes.
- The efficient investment allowance determined by the AER for the network service provider adopting benchmark financing assumptions should be financeable if the rate of return is efficient and commensurate with risk and the revenue provided in the post-tax revenue model is consistent with the rate of return provided.
- If returns are sufficient, actual investment should closely match the efficient allowance.

The AER's working paper seeks to consider whether the approach to setting the rate of return and the cashflows from regulated services remain appropriate in a low interest rate environment. The AER expressed the view that we are in a low interest environment recognising that:

<sup>17</sup> AER, Term of the rate of return, Draft working paper, May 2021, p.18.

<sup>18</sup> *ibid*, p.39.

*... there has been a prolonged decline in interest rates and key measures of interest rates are lower than they have been for some time.<sup>19</sup>*

We support an ability to smooth significant volatility in markets and remove the impact of anomalous market conditions (such as Reserve Bank of Australia intervention). However, the focus of the regulatory regime should be ensuring that any change in methodology is not implemented in a biased manner. A change in method should not be applied to reduce the benefit/loss to investors or consumers when the benefit or loss in the other direction has already been incurred.

There are three key aspects that we wish to comment on:

- The relationship between the market risk premium (MRP) and the RFR
- The value of financeability assessments in providing a cross check on internal consistency and overall reasonableness of the rate of return
- The AER's view that financeability should be principally managed by regulated firms through gearing, dividend reduction and other means.

### Relationship between MRP and RFR

Over time, the AER has altered its view on both the data required to estimate the MRP and its relationship with the RFR:

- Prior to 2013, the AER accepted an inverse relationship and estimated an MRP using forward looking data that moved in the opposite direction to bond rates.
- In the 2013 rate of return guideline, the AER also recognised an inverse relationship and used forward looking data to apply a constant MRP that was increased when bond rates fell.
- In 2018, the AER rejected the inverse relationship, relied solely on historical returns and reduced the MRP when bond rates fell.

The AER's change in the 2018 RORI related entirely to a change in methodology rather than a change in the cost of equity and was contrary to expert advice available at the time. The AER now appears to be accepting a relationship to dampen changes when the risk free rate is more likely to increase than decrease. On the face of it, such an approach would appear to be biased.

We agree that adopting an inverse relationship is consistent with experts, market practice and estimates of the cost of equity. However, if the AER were to change its methodology yet again, then it needs to pay careful attention to market practice in determining market estimates of the cost of equity and not disregard or discount the advice of experts and finance practitioners.

In the 2018 RORI, most experts agreed that there was a relationship between the MRP and RFR in estimating the cost of equity that lay somewhere between the constant MRP or constant total market returns. Yet the AER adopted a constant MRP. Experts agreed that forward looking information such as dividend growth model estimates, surveys and historical excess return information should be used to estimate the market risk premium. The AER accepted this but applied a zero weight to dividend growth model estimates and surveys.

Neither market practitioners nor valuation experts adopt a short-term risk free rate with a long term MRP. Instead, they match a long term risk free rate (or blend) with a long term MRP – or adjust the MRP. Indeed, the increased volatility in the RFR has resulted in a more volatile MRP and upward adjustment to reflect the anomalously low government bond yields.

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<sup>19</sup>

AER, Rate of return and cashflows in a low interest rate environment, Draft working paper, May 2021, p.3



In the 2018 concurrent evidence sessions, Mr Ilan Sadeh, then with Hastings Funds Management, indicated that independent valuers have typically applied an MRP over a long term average risk free rate and that this approach is consistent with applying a MRP of 6.5% on the spot rate<sup>20</sup>:

*My observation is that MRP done by independent valuers in the unlisted investment market hasn't changed since before I had hair, which is a long time ago. Upwards of almost 20 years I haven't seen the two major independent valuation firms in Australia change their number on MRP by a dot.*

*... the difference is, the typical independent valuer approach does that as a premium over a long term average risk free rate. That goes to the point about 6 per cent. I think the AER's last was 6.5 per cent which I think is consistent with what might be more of a 6 per cent over a long term average. ... When you look at all the different independent valuer risk free rate plus MRP, it averages 0.7 of a per cent since 2000 over a spot rate instead. So I think 6.5 per cent over spot compares to 6 over long term average.<sup>21</sup>*

Since then, the AER has continued to be presented with evidence that supports a long term approach that addresses volatility.

Mr David Johnston (Queensland Treasury Corporation) also presented evidence supporting both that falls in bond rates were not matched with falls in expectations of equity returns, and MRPs used by valuation experts increase with falls in bond rates. Ultimately, he argued that:

*The 2022 RoRI must produce the best return on equity estimate across a wide range of future (uncertain) capital market environments. On an ex-ante basis, combining multiple MRP estimation approaches is more likely to achieve this outcome.<sup>22</sup>*

David Johnston referred to the example from the KPMG survey of valuation practices which found that Australia has the highest market cost of equity of the selected developed economies at 8.8%.<sup>23</sup> This is not consistent with a theory that equity returns have fallen one-for-one with bond rates.

In September 2020, Mr Rob Koh (Morgan Stanley) referred to using a MRP of 6% matched with a mix of spot and long term average risk free rate, not a 10 year spot rate.<sup>24</sup> In June 2021, Mr Koh confirmed this methodology and the use of long term average with a tenor that matched investments of 30-40 years and referred to this producing a risk free rate of about 3.5% and an equity IRR of between 6-8%. Indeed, Mr Koh stated that he was not aware of anyone that uses a spot risk free rate without making an adjustment to beta or risk premium.<sup>25</sup>

Confidential valuation analysis that some NSG members have access to also supports the application of a MRP to a long run historical rate or the application of an additional premium when the MRP is used with a 10-year spot government bond rate. Most valuation practitioners adopt the yield on government bonds of a term matching the cash flow projection period as a proxy. However, current yields are unlikely to be maintained in the long term and are not necessarily reflective of a long term risk free rate for estimating an appropriate cost of equity. In practice, many valuers have either used a normalised risk free rate,

<sup>20</sup> The CGS 10-year rate was approx. 2.7% in April 2018.

<sup>21</sup> Ilan Sadeh, Hastings Funds Management, AER concurrent evidence sessions, 5 April 2018.

<sup>22</sup> David Johnston, Queensland Treasury Corporation, Some high-level observations on the market cost of equity, AER forum, 16 September 2020.

<sup>23</sup> KPMG (2020), Valuation Practices Survey 2019: What's it worth? Determining value in the continuing low interest rate environment, p.5.

<sup>24</sup> Rob Koh, Morgan Stanley, AER forum, 16 September 2020.

<sup>25</sup> Rob Koh, Morgan Stanley, AER forum, 23 June 2021.

increased their estimates of the MRP or have included an additional risk factor in their calculations of the cost of equity.

The AER needs to demonstrate that it has used market information and practice in its decision-making process to assess whether the estimate is the best unbiased estimate of an efficient return on equity – and most importantly whether the theoretical view of returns on equity will actually support the attraction of capital.

### Financeability assessments

The AER has indicated that it is aiming for an unbiased estimate of the expected efficient return, consistent with the relevant risks involved in providing regulated network services. However, it has also acknowledged that ‘setting the expected rate of return is not a precise science and involves uncertainty and judgment’.<sup>26</sup>

Recognising this imprecise science and the risks of getting it wrong,<sup>27</sup> financeability assessments are an important tool used by many regulators around the world to test the reasonableness of rate of return estimates. They have been used extensively by regulators in the United Kingdom (such as OFWAT and OFGEM) and by IPART in the context of water regulatory decisions. It is unclear why the AER has rejected the use of financeability assessments so strongly when other regulators use them either by choice or by law.

Undertaking a financeability assessments is important to:

- provide confidence in regulatory decision-making process and outcomes
- test that assumptions used in making a decision are internally consistent
- ensure that a regulated network service provider adopting the same benchmark financing assumptions can finance efficient investment at the regulated return
- minimise the cost and impact on consumers of failing infrastructure, poor reliability and higher long term investment costs.

For these reasons, financeability assessments are critical to achieving the long term interests of consumers. They provide a lead indicator of the sufficiency of returns to attract capital to undertake efficient investment. They are also particularly important given that there is no other process or recourse available in the current regime for appealing or challenging decisions which create adverse outcomes. We do not understand why the AER would choose not to apply a test that could demonstrate transparently the veracity of its regulatory decision making and minimise the risk of getting it wrong.

We note that the ENA has previously sought advice from NERA Economic Consulting on the role of financeability in promoting the long term interests of energy consumers.<sup>28</sup> This advice sets out the key dimensions of a financeability test that should be considered by the AER including whether it be based on a benchmark efficient entity, methodology and calculations, frequency of testing and remedies. We welcome the AER’s further engagement on its proposed methodology and approach in relation to financeability assessments.

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<sup>26</sup> AER, Assessing the long term interests of consumers, Position paper, May 2021, p.2.

<sup>27</sup> *ibid*, pp.8-9.

<sup>28</sup> NERA Economic Consulting, Role of financeability in promoting the long term interests of energy consumers, Prepared for Energy Networks Association, 10 December 2020.

## Alternative approaches for regulated firms to achieve financeability

We note the AER's comment that 'The regulatory framework does not require network service providers to be able to achieve the benchmark assumptions used in making and applying the RORI at all times',<sup>29</sup> and that financeability should be principally managed by regulated firms including by varying their capital structures and targeting a credit rating based on their specific position and objectives.<sup>30</sup> At the same time, the AER acknowledges that the rate of return should be set to 'provide the business funds to service the interest on its loans and give a return to shareholders'.

It is not acceptable for a regulated business adopting benchmark assumptions and undertaking the efficient levels of investment set out in a determination to not achieve and maintain the credit rating assumed by the AER when establishing the cost of capital in the RORI. This would require a regulated business to draw on the revenues and balance sheet of unregulated services or a related party to enable it to provide regulated services at the efficient cost. Not only is this inconsistent with the revenue and pricing principles, but it also contravenes the principle underpinning ring fencing requirements that regulated service revenue should not subsidise unregulated services and vice versa.

Similarly, if a regulated business is required to change gearing to achieve the RORI, that gearing should be used to estimate the efficient cost of capital in the RORI. The RORI applies to all network service providers and all investments. There is no premium provided for major projects or for undertaking investments that would be unfinanceable at the capital cost provided in the regulated return. If it is efficient for a different gearing to be adopted, the return provided must be consistent with that gearing assumption. Otherwise, the return is not commensurate with the risk of the higher gearing level.

The AER's view that dividend reduction can help financeability is inappropriate and inconsistent with the regulatory framework. If a network service provider adopting the same benchmark financing assumptions must reduce dividends to finance investment, this is the same as saying that these investors should expect to receive a return on equity that is less than that set out in the RORI. That is, the AER has determined that those investors should receive an equity return that is less than that set out in the RORI by which it is bound.

In practice, investors have regard to the return trade-off that represents reinvesting dividends versus distributing them. An investor would only reinvest if they expected a return equal to or higher than their cost of capital. Currently, the trade-off is likely to be negative, that is distributing dividends seems the most logical approach versus deferring them, particularly given the expected return is not only less than investors' cost of capital but less than the equity return set out in the RORI.

In the 2020 Performance Report, the AER concluded that returns were sufficient based on transaction and trading multiples during a period in which the 2018 RORI was not relevant or applied. Adopting a financeability assessment that is broadly applied elsewhere and understood, or an alternative that is outlined in advance, will avoid the potential for inadvertent erroneous conclusions to be relied on by other stakeholders such as consumers, market bodies and government.

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<sup>29</sup> AER, Rate of return and cashflows in a low interest rate environment, Draft working paper, May 2021, p.47.

<sup>30</sup> *ibid.*, pp.77-78.

## Consultation Paper on 2022 Instrument Process

### Key messages

- The expert joint report is a key activity to support transparency and accountability and should be retained.
- We wish to nominate experts for the expert conclave and Independent Panel.
- The scope of the Independent Panel's task should include assessing how the AER has determined that the estimate is the best unbiased estimate and the role of the process and treatment of information in forming the determination.

### Independent Panel and use of experts

The AER's most recent consultation paper noted that the AER is required to draw on concurrent expert opinion and evidence about the proposed instrument and to establish an Independent Panel to give the AER a written report about the instrument.

We support the continued use of experts and access to the discussion by all stakeholders:

- If the AER wishes to use an expert conclave, then we are strongly of the view that the experts must be representative and reflect nominations from across various stakeholder interests.
- It is appropriate for the AER to fund the experts on the basis that the expert advice should be shared across all stakeholders, and this avoids the perception that experts are being funded to further stakeholder interests. Care should be taken to ensure that conflicts of interest are avoided or declared.
- Transparency of the expert opinions is crucial in avoiding any perceptions that experts funded by the AER are representing AER views rather than their own.
- A shared report should be prepared as this provides a useful aid for stakeholders to understand various views, to improve the quality of submissions and for the AER to demonstrate how it has considered the expert opinion.

In relation to the Independent Panel, we support a five member panel with a range of expertise. We feel strongly that an understanding of capital finance and/or institutional investment experience are important competencies for the Independent Panel. We also support the AER giving stakeholders and experts an opportunity to make short submissions directing the Panel to core issues of concern as this will ensure that the Panel's efforts are well directed and provide maximum confidence in relation to the final outcome.

We note that the legislation is vague about the questions to be addressed by the Independent Panel, and this is left to the discretion of the AER. Considering the AER's proposed guiding principle focused on the AER producing the best unbiased estimate,<sup>31</sup> we consider that the Panel should provide its view on whether the AER's estimate is the best unbiased estimate of the expected efficient return consistent with the relevant risks involved in providing regulated network service as well as how the AER has assessed its estimate against its objectives (including the NEO/NGO). Focusing on a narrower question will not provide confidence that the AER's process and approach will achieve its guiding principles and the objectives of the NEO/NGO.

We are not proposing that the Independent Panel's views substitute for the AER's judgement but rather provide an opportunity for the AER to improve the robustness of the outcome and reasons.

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<sup>31</sup> AER, Assessing the long term interests of consumers, Position paper, May 2021, p.1.