AER Consumer Reference Group

AER public forum
Cashflows in a low interest environment

(The “LIRE paper”)

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Who we are:

AER Consumer Reference Group

An independent group set up to:

- Advise the AER on its consumer engagement and
- Represent the perspectives and interests of consumers
- In the context of the RORI review

Our role derives from the National Electricity Law and National Gas Law

Bev Hughson – Chair Kieran Donoghue – Deputy Chair

Allan Asher Helen Bartley Ron Ben-David Jo De Silva

Craig Memery Alex Oeser Lynne Gallagher (ECA)

https://www.aer.gov.au/about-us/stakeholder-engagement/consumer-reference-group

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This paper has been published primarily to answer three 'headline' questions

Are we in a low interest rate environment (LIRE)?	**AER: Yes**	**CRG: ✓**
Is the regulatory framework still applicable in a LIRE?	**AER: 'Yes'**	**CRG: ✓**
Does financeability need to be addressed in the RORI?	**AER: No**	**CRG: ✓**

Why has this paper been deemed necessary?

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- In response to stakeholder concerns

  CRG: What is the AER's threshold for considering 'concerns' ?

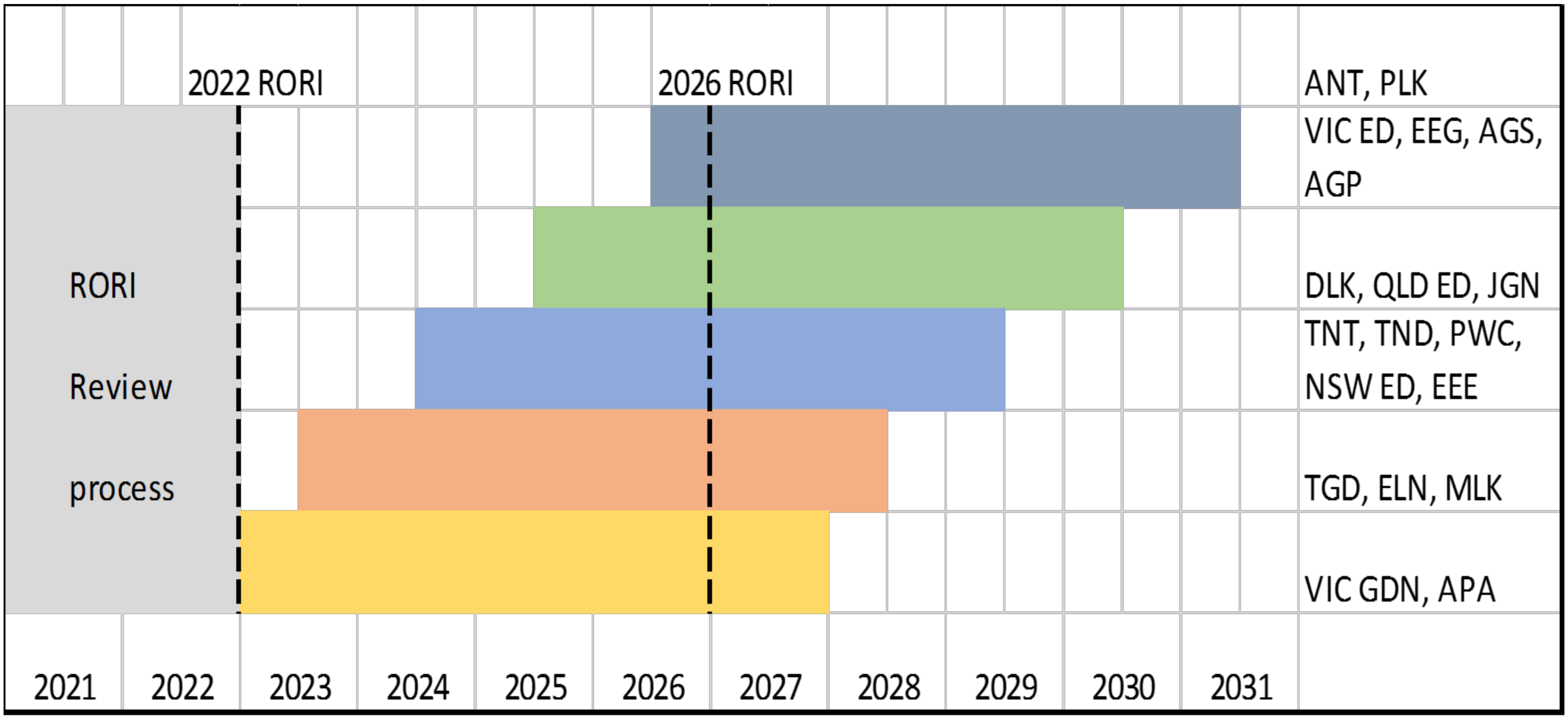
  CRG: Where's the *hard* evidence (vs Frontier paper for Vic DNSPs)?

- Unprecedent circumstances

  CRG: What are the implications of declaring an "environment" for financial markets at the time of a review?

  CRG: How relevant is the *current* environment to the RORI, when its impact runs out to 2031?

RORI and determinations timeline



We are in a "LIRE" but there has been an uptick since the Frontier report

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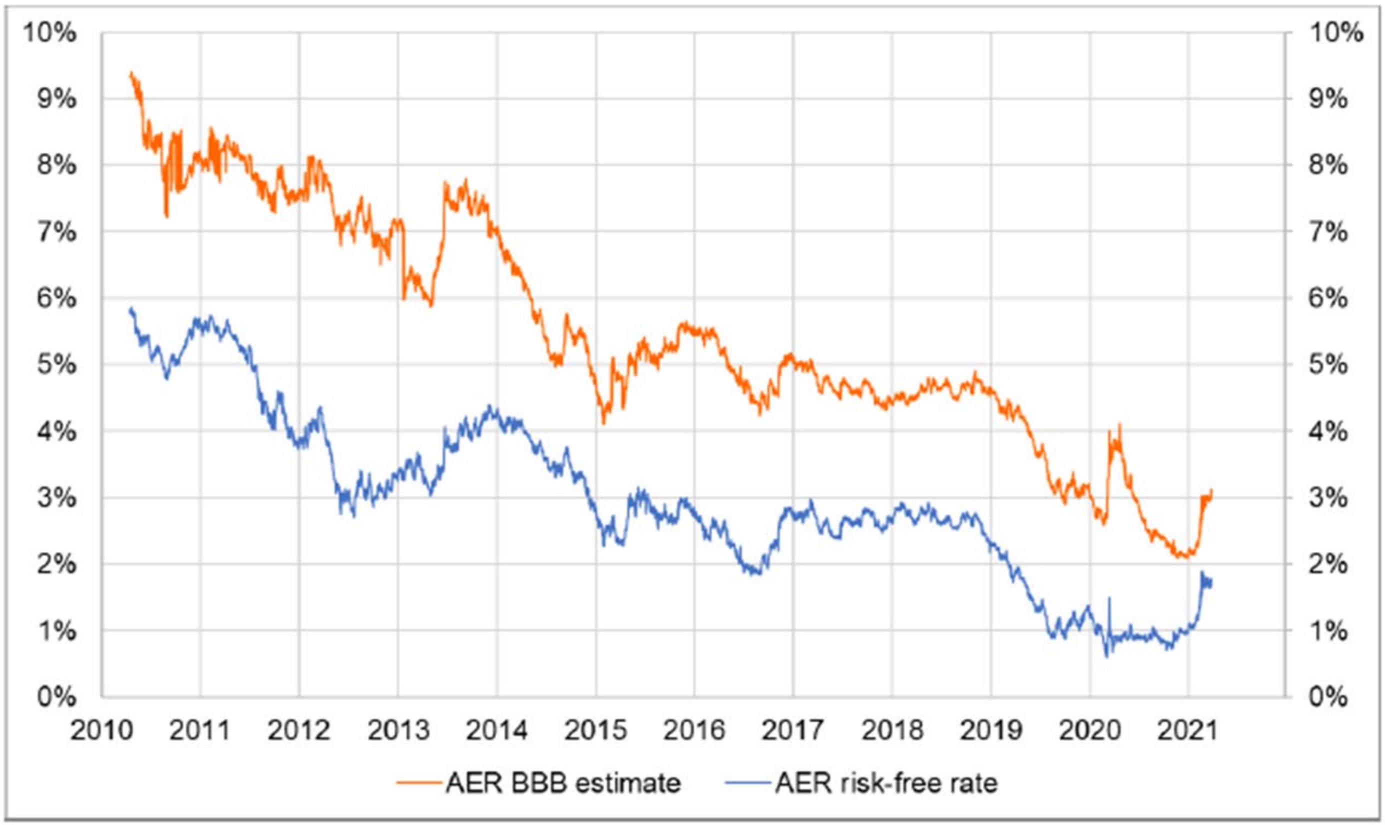
Figure 9 Comparison of AER BBB estimate and AER risk free rate (May 2010 to February 2021)



Sources: RBA; Bloomberg; AER

What's really motivating all of this?

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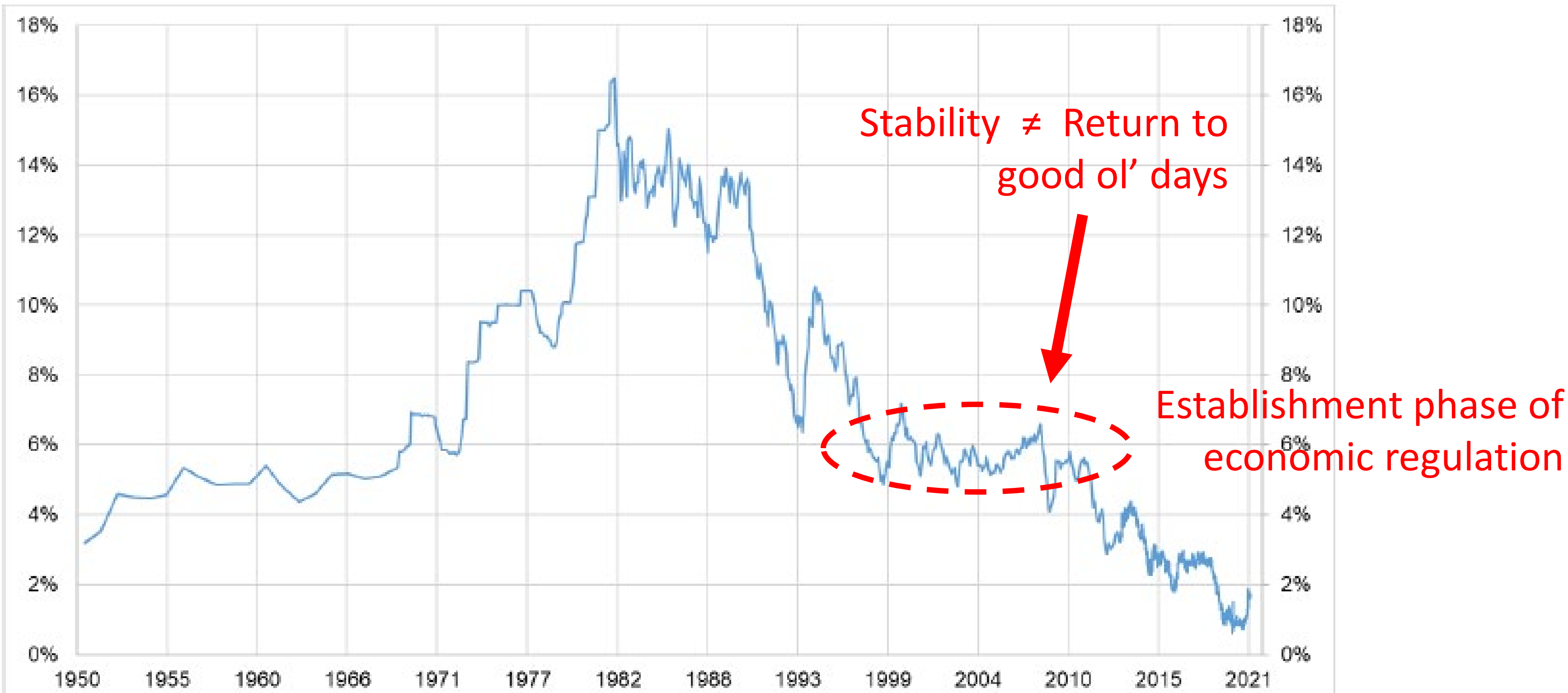
Figure 3 Historic Australian interest rates on 10 year Government bond yields



Source: RBA

Networks have focussed on the downside of a LIRE but they have benefited on its upside.

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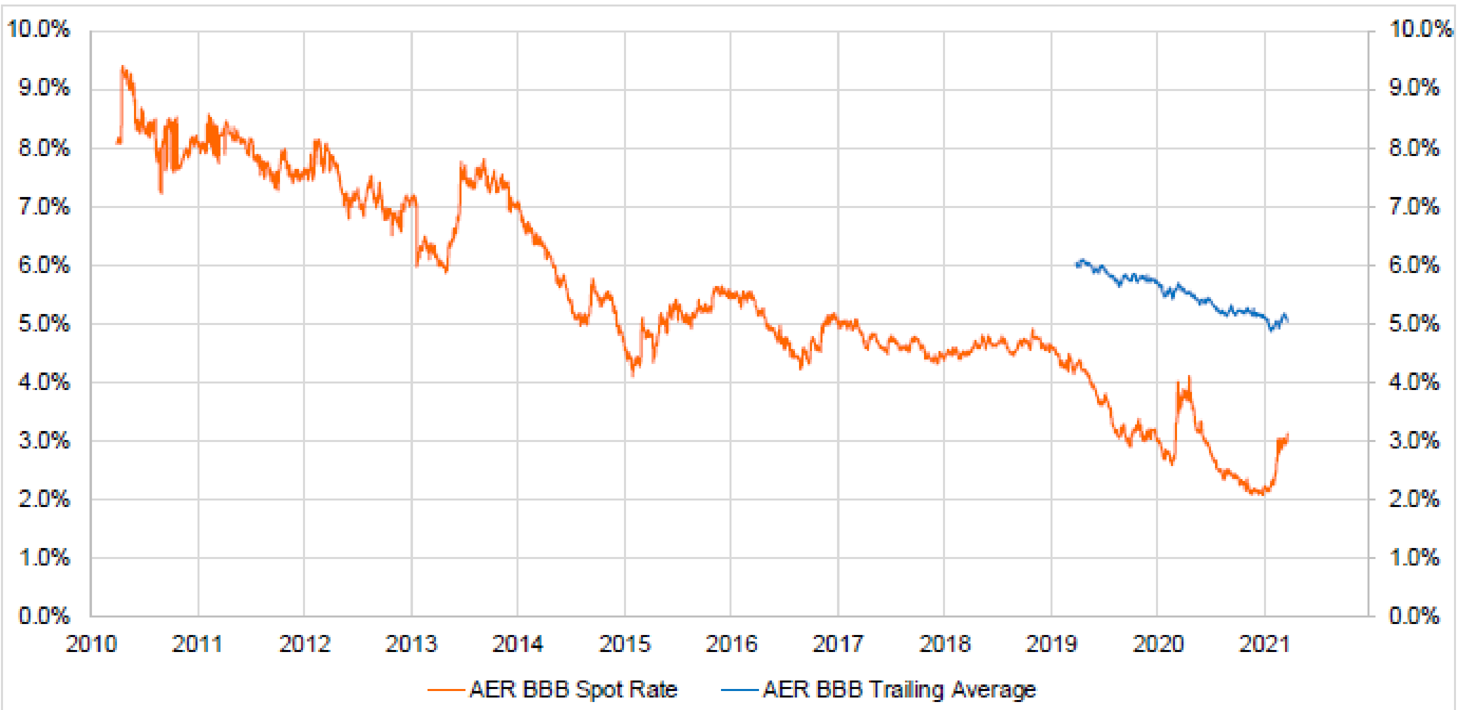
Figure 19 Risk free rate step change response, trailing average vs. spot rate



Sources: RBA; Bloc

Beyond the trailing average approach to debt (2013), other measures de-risking networks include: Inflation decision (Dec 2020), proposed approach to RoE term (May 2021), MRP review (LIRE paper) and then: RAB indexation, cost pass throughs & incentive schemes.

Financeability

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We agree with AER (and AEMC) that financeability is a matter for the network businesses to manage, implying the framework and methodology (and the not the RoR) should be **stable** and applied consistently.

We do not agree with networks perspective that financeability can be boiled down to a single quantitative measure such as a threshold value for FFO/debt (or that it can be looked at a single point or period in time).

The role of the RORI is to outline a 'generic RoR'. To the extent there are specific issues that intersect with the regulatory framework (e.g. ISP projects), best they are considered on a case by case basis – **BUT** we are deeply concerned, however, about these projects becoming a "thin edge of the wedge" for further unravelling of the regulatory framework.

Further reflections on the LIRE paper

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- The AER has not previously assessed the type of environment in which it is making regulatory decisions. The working paper offers no insight into when such assessments will or won't be triggered in future – or what their consequences would be for the regulatory framework.
- Chapter 4 commits the AER to assessing whether there are relationships between the risk free rate (RFR) and the MRP, beta, DRP and gearing ratio (G).
    - If significant relationships are found, it would seem to suggest the CAPM cannot be used as the AER's "foundation model" – noting AER's final position paper on CAPM in Dec 2020.
    - It appears the AER will be using 10 year values to assess these relationships – but the "Terms" paper proposes shorter terms. It does not necessarily follow the same conclusions will hold over 10 year and 5 year estimates.
    - The AER has not yet established how it will estimate these inputs over a 5 year term, so how does it intend to explore the relationship between those estimates and the RFR?

The CRG’s five principles / criteria

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Principle 1 – A regulatory framework serving the long-term interests of consumers <u>must promote behaviours that engender consumer confidence in the framework</u>.

Principle 2 – Any change to the regulatory model must be tested against detrimental consumer impacts in relation to absolute prices and price changes.

Principle 3 – Any change to the regulatory model must be tested against acceptable consumer impacts.

Principle 4 – Risks should be borne by the party best placed to manage them.

Principle 5 – There should be a <u>high bar for change</u>.

Customer perspectives

Our consultations with consumer representatives clearly indicates:

- Preference for stable approach that looks across economic cycle(s)
- Frustrated by lack of clarity about why these reviews are required
- Suspicious of unending cycle of reviews *and the motives behind them*

CRG:

- Where's the *quid pro quo* for consumers when the AER responds to networks and reviewing every element of the RoR? (vs dire 'warnings')
- AER seems to be gradually de-risking the RoR for networks? Inflation (Dec 2020), Terms paper, Trailing average 2013. Is the benefit being shared fairly with consumers?
- Why doesn't the AER demand a *quid pro quo* for this constant tinkering?
- We make these observations in the context of the following statements…

The working papers recognise the challenges associated with reviewing the RoR.

> *"Estimating the rate of return is difficult and contentious. It requires regulatory judgement to assess the complex and sometimes conflicting evidence; and to engage with finance theory, academic literature and market practice. There is no one 'right answer' to be found."*
>
> (Terms paper, p.2)

> *"For return on equity, experts and regulators often reach differing positions on the strengths and weaknesses of different models and how those models should be implemented."*
>
> (LIRE paper, p.22)

These quotes would seem to suggest that a change to the regulatory approach should only proceed when a comprehensive case for change has been made.

The LIRE paper concludes (p.48)

*"**The current regulatory framework provides investors with a stable and predictable regulatory investment framework** that includes an ex-ante return on their investments. This allowed return should be commensurate with the efficient financing costs of these regulated investments. As we noted in our 2018 Instrument Explanatory Statement, we consider this is reflected in the prevailing market cost of capital (or weighted average cost of capital) for an investment with a similar degree of risk as that which applies to a service provider in respect of the provision of regulated services. The process for setting revenue and capital expenditure forecasts in regulatory determinations is clearly laid out in legislation."*

Conclusion

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We generally agree with the AER's answers to the three questions its sets out in the LIRE paper. But…

- Assessing the "environment" establishes an uncertain precedent, without any clarity about triggers, thresholds & consequences.
- What exactly does the AER hope to achieve by investigating relationships / correlations (±ve) between inputs to the CAPM & WACC formulae?
- These endless reviews are seemingly triggered to appease the networks, but why is nothing demanded from them in return?
- How do networks and the AER think all of this looks to consumers?

The CRG was established to provide answers to that last question. We have talked to advocates and surveyed a wide cross section of residential and business customers. They consistently emphasise the value of **fairness, stability and predictability**. We expect more recognition of these values in the network's arguments and the AER's decisions.