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SUBMISSION ON AER'S EQUITY BETA ISSUES PAPER – OCTOBER 2013

The Financial Investor Group (FIG) is an affiliation of the major private investors in Australian energy network assets. The FIG therefore has a strong interest in how Australia's energy network infrastructure is regulated, both directly and on behalf of its members' investors.

Consistent with this, our submissions to the Rate of Return Guideline process aim to bring a commercial and practical perspective to regulatory debate on the rate of return. The FIG believes this perspective is critical because it is the same one that investors bring when making investment decisions, which ultimately result in equity capital being made available to regulated network providers to enable efficient investment in energy services in the long term interests of consumers.

The FIG provides these comments in the context of the AER's recent release of its discussion paper on the equity beta, a key component of the AER's foundation Capital Asset Pricing Model. Now that the final piece of information relating to the AER's foundation model is on the record, the FIG welcomes this opportunity to comment on the AER's framework.

A key concern of the FIG, consistent with various other submissions to the draft Rate of Return Guideline, is the lack of certainty regarding the allowed rate of return that will be determined by the AER. This reflects a number of matters, including the decision of the AER not to include a contemporaneous example range for the MRP in the final guideline and a lack of transparency over the role that certain other information will have in setting the allowed cost of equity.

One of the key themes in both the AEMC Rule Determination and the AER draft Guideline process has been to provide certainty to investors. In particular, one of the goals of the process is that investors should be able, with a reasonable degree of certainty, to estimate the rate of return that would result from the AER's application of its Guideline. The FIG considers that the wide range for the relevant parameters will drive a wide range of outcomes for the rate of return on equity; it will not be possible for a service provider to estimate its allowed rate of return on equity with any degree of confidence.

However, the AER has provided considerable information to allow a service provider to estimate the likely *maximum* return on equity that the AER will allow:

The AER has now made the following clear:

- it will rely heavily on its "Foundation Model" (the Sharpe–Lintner Capital Asset Pricing Model):[1]

  We propose to use the Sharpe–Lintner CAPM as the foundation model

- The allowed cost of equity must fall within the range specified by its parameterisation of the CAPM:[2]

  Moreover, the final point estimate will be selected from within the foundation model range.

  Our proposed approach is premised on the expectation that the analysis in step five should not suggest a final estimate of the return on equity outside the foundation model range.

  The range and point estimate for the return on equity will be calculated based on the range and point estimates from the corresponding input parameters. For example, the lower bound of the return on equity range would be calculated by applying the point estimate for the risk free rate and the lower bound estimates for the equity beta and MRP.

  and by extension, the upper bound of the return on equity range would be calculated by applying the point estimate for the risk free rate and the upper bound estimates for the equity beta and MRP.

- In estimating the Market Risk Premium, it will rely on historical excess return studies, surveys, and other information as it has done historically:[3]

  The MRP range will be estimated with regard to theoretical and empirical evidence — based on evidence such as historical excess returns, survey evidence, financial market indicators, estimates from other regulators, and dividend growth model estimates.

  The market risk premium point estimate would be determined based on the AER's regulatory judgement, taking into account estimates from each of those sources of evidence, including their strengths and limitations.

The use of these models will be tempered by the AER's views on their usefulness and reliability. The AER has historically placed very little weight on dividend growth model estimates.[4]

Based on the recent Victorian Gas Access Arrangement Review,[5] the FIG considers that it will be very difficult indeed for the AER to apply the same methodology it has applied previously and result in an MRP that departs materially from 6%.[6]

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[1] AER Explanatory Statement p62.
[2] AER Explanatory Statement pp64, 65.
[3] AER Explanatory Statement p64, AER draft Guideline p17.
[4] Refer, for example, the extensive discussion in Appendix B of the APA GasNet Final Decision, March 2013.

- its range for the equity beta is 0.4 to 0.7, and it has landed on a point estimate at the top of the range, 0.7:[7]

  After considering the evidence currently before us, we propose to adopt an equity beta point estimate of 0.7 for a benchmark efficient entity, chosen from within a range of 0.4 to 0.7.

Summarising the information the AER has released to date, the maximum allowed return on equity will be provided by the application of the CAPM with the various parameters set at the top of their respective ranges:

$$\begin{aligned} MAX(RoE) &= Rf + MAX(Beta) \times (MRP) \\ &= Rf + (0.7) \times (6.0\%) \\ &= Rf + 4.2\% \end{aligned}$$

The FIG considers that, taken together, this information indicates that the AER is of the view that investors will be prepared to invest in long-lived infrastructure assets at a cost of equity no more than 4.2% greater than the currently observed risk free rate.

The FIG is most concerned about the nature of the signals that this information sends to investors and to the market in general.

The FIG is concerned that the AER's signalled maximum return on equity will create headwinds for capital raising; infrastructure businesses may not be able to compete for capital in global marketplaces as investors redirect capital to other investments with a superior risk-adjusted return.

This would inevitably have negative implications on the necessary investment in infrastructure assets, with cascading implications for Australian businesses that rely on that investment in infrastructure. Ultimately this questions the achievement of the National Electricity and Gas Objectives by not promoting and encouraging efficient investment in energy networks and services, and will lead to long-term concerns over the reliability, safety and security of our national energy systems.

We would be pleased to discuss these matters with you in greater detail. Please ring Scott Young of APA Group on (02) 9275 0031 in the first instance.

Yours faithfully

Peter Bolding
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APA Group
On behalf of the Financial Investors Group

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[5] Refer, for example, the extensive discussion in Appendix B.3 of the APA GasNet Final Decision
[6] The FIG has assumed a point estimate for the MRP of 6% based on recent AER decisions, including the most recent Victorian Gas Access Arrangement Review process, although the FIG recognises that clear guidance on this parameter is yet to be provided by the AER.
[7] AER beta issues paper, p6.