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DRAFT WORKING PAPER: RATE OF RETURN AND CASHFLOWS IN A LOW INTEREST RATE ENVIRONMENT

Endeavour Energy appreciates the opportunity to respond to the AER's draft working paper on its review of the rate of return (ROR) and cashflows in a low interest rate environment (paper or financeability paper). This paper follows concerns raised by networks regarding the impacts of low interest rates on the 2018 Rate of Return Instrument (RORI) outcomes in recent determinations.

Specifically, that in certain market conditions the 2018 RORI can produce either unsustainably low or high returns. In a low interest rate environment the financial metrics the ROR may produce for a Benchmark Efficient Entity (BEE) prevents the BEE from maintaining its assumed BBB+ credit rating. A deterioration in the credit rating of networks would increase the cost of debt reducing their ability to finance efficient and prudent investments and increasing future costs to addressing the long-term interests of customers.

In response, the paper considers three broad questions and concludes the following:

1. **Whether we are in a low interest rate environment:** the AER concludes, un-controversially, that there has been a prolonged decline to a historic lows in interest rates.
2. **If so, the consequences of low interest rates:** the AER notes its approach to calculating the RORI means that declines in interest rates flow through to its return on debt and equity estimates. The latter is more directly linked to movements on Commonwealth Government Securities (CGS). This has impacted network cash flows and associated measures such as Net profit after tax (NPAT) and Funds from operations (FFO) to net debt.
3. **Whether changes to the RORI are required:** the AER's preliminary position is:
    a. Debt: The trend in its estimation of the cost of debt and interest rates has been and remains appropriate.
    b. Equity: Using CGS as a proxy for the risk free rate remains appropriate. However, the equity working paper may reconsider the best estimate of the relationship between CGS yields and the expected return on equity.
    c. Overall: Financeability considerations should not be used to directly adjust the ROR, largely as per the reasons contained in the AEMC's review of the TransGrid and ElectraNet rule changes as well as further advice from the ACCC Regulatory Economics Unit (REU).

With respect to financeability, we do not consider the questions above are the best way of approaching this issue. It is not appropriate to start from the premise that the existing RORI operates effectively nor is it being suggested that a financeability test be used to deterministically adjust the RORI. Rather than re-prosecute the TransGrid and ElectraNet rule change, this workstream would be better served by reviewing whether the current environment indicates any existing parameter is not working effectively and examining whether including financeability checks as part of the RORI process would help produce a ROR that better promotes the long term interests of customers.

In our response to the draft working paper we provide this brief response highlighting our key concerns and suggestions. For our more detailed position we refer the AER to the ENA's submission to this review, which we fully endorse.

What is financeability and why is it important?

It is important to establish a clear definition of financeability and its potential role in the regulatory framework. We propose that financeability is one of the cross-check tools that the AER can use to test the adequacy of the allowed return. This would involve applying the draft and final 2022 RORI through

the Post-Tax Revenue Model (PTRM) using a notional BEE and 'stress testing' against various scenarios (e.g. a firm in a capital investment phase). Where the benchmark credit rating is not supported it could trigger a re-examination of ROR components rather than being used mechanistically to make adjustments.

A financeability test does not need to examine the circumstances of an individual firm to check whether it may be able to raise capital or avoid insolvency. Instead, we see it as a forward-looking, preventative measure to ensure the overall ROR:

1. delivers a financial outcome consistent with the BEE credit rating assumption underpinning it; and;
2. is reasonable and robust under a range of potential scenarios.

This would support the long term interests of customers as credit downgrades will flow through to the benchmark credit rating in future periods and increase the allowed return on debt. It would also reduce the risk of networks having to raise new debt at a premium over the allowed return during a period which may undermine the commerciality of otherwise efficient and prudent investments.

Given its potential value as a preventative measure we do not support the AER's rationale in dismissing introducing a test because, inter alia, networks are not currently in position of financial distress or can raise capital through other sources:

> *There are a number of sources of funding available to a NSP to meet its financing requirements, including:*
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> - *using retained earnings, that is reducing dividends.*
> - *issuing new debt - all NSPs we regulate do this, and the cost of debt is influenced by the credit rating assigned by credit rating agencies.*
> - *issuing new hybrid securities (such as AusNet who currently does this).*
> - *raising new equity through other capital raisings or right issues including dividend reinvestment plans…….*
>
> *…….In looking at this we found no evidence that the NSPs we regulate cannot efficiently raise capital. There appears to be a range of options NSPs take to optimise their overall capital structure and to make regulatory investments financeable. Furthermore, it appears the NSPs we regulate have been able to manage their capital structure and cash flows to maintain investment grade credit ratings.*

As aforementioned, financeability should not simply be about testing whether a firm can raise capital. Notwithstanding this, even by the reasoning in the paper we consider there is evidence to suggest networks are in a position of financial distress and that a more direct consideration of financeability in setting the RORI is warranted under either rationale as detailed further below.

As noted in the paper we are in a historically low interest rate environment as evidenced by government bond yields and interventionist monetary policy by the RBA. Further, across the industry we have observed a historically low allowed return on equity. The 2018 RORI resulted in a 24% reduction to the allowed real return on equity which has fallen a further 36% due to the subsequent decline in government bond yields (a combined impact of 51%).

These returns are well below those allowed by comparable international regulators as established by benchmarking reports and research from Brattle[1], Farwacker[2], Morgan Stanley[3] and the Council of European Energy Regulators[4]. These comparably low returns in a period of historically low returns has resulted in:

- Negative NPAT in some decisions.
- Credit rating downgrades for some networks.
- Some networks unable to pay distributions.

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[1] The Brattle Group, A Review of International Approaches to Regulated Rates of Return, June 2020, pp. 49-50

[2] Earwaker, J., The AER's draft WACC Guideline: An international perspective, September 2018, p. 12

[3] Morgan Stanley Research, Utilities Global Lens: Where to Invest in Regulated Utilities Amidst Global Macro Environment, 5 April 2021.

[4] CEER, Report on Regulatory Frameworks for European Energy Networks 2019: Incentive Regulation and Benchmarking Work Stream, Ref: C19-IRB-48-03, 28 January 2020.

- Some key investments are uneconomical for private investment and cannot proceed without taxpayer underwriting.

It is unsustainable to set a ROR below a financeable level, or allow it to deteriorate below and efficient level over time due to changes in the environment, and to assume that the observed outcomes are temporal or part of a NPV neutral cycle:

> *We consider it is not problematic if NPAT for our NSPs becomes negative. Under our framework, even if NPAT is negative over a period of time, the expected NPAT over the life of the investments will be positive. If negative NPAT over the short term is a concern, a NSP is able to take action to address this problem by raising additional equity (changing the gearing).*

A ROR cannot be set on the basis of the assumption that a period of under-compensation will be offset by some unspecified, assumed future period of over-compensation. The best estimate of an efficient return is required each period or determination. We submit that based on the market evidence and benchmarking of allowed returns the best possible estimate of the market cost of equity capital in the prevailing conditions has not been provided to date.

A financeability test could form part of a suite of changes to address this issue. We note several international regulators in similar regimes adopt financeability tests, some voluntarily as part of good regulatory practice. As noted by IPART in its 2018 review of its financeability test[5]:

> *Our final decision is to continue to conduct financeability tests, as stakeholder feedback and our analysis both support this decision. Our view is that our financeability test is effective, and the potential benefits of the test in highlighting a potential future financeability concern are high compared to the small regulatory cost of conducting the test.*

Does the low interest environment require changes to estimation of the rate of return?

In addition to considering the introduction of a financeability test, the paper also considers whether changes are required to any individual return parameters. The AER concludes that its approach to debt and equity remain appropriate. However, with respect to latter the AER will consider the relationship between the risk free rate and the market risk premium (MRP) further.

Risk-free rate

We support the AER's position that the current low interest rate environment does not suggest any change in its approach to estimating the efficient return on debt allowance is required. We do however submit that further review of the return on equity is required, specifically the appropriateness of the risk free rate.

This is because of the implied yield in government bonds that is not relevant to setting the CAPM risk-free rate. Whilst government bonds are effectively risk-free, which is appropriate for estimating the return required on a CAPM zero beta asset, they also possess special liquidity and safety characteristics that mean market participants are willing to accept a lower yield. This aspect of government bonds is not suited to setting the CAPM risk-free rate more generally as investors cannot borrow at the prevailing government bond yield (which includes the convenience yield). There are regulatory precedents for recognising these issues in adopting a CAPM risk-free rate above the prevailing government bond yield as well as academic and market support for this practice.

In addition to this, in the current low interest rate environment the RBA has intervened in the market for short-term Australian government bonds to achieve a reduction in the cash target rate to 0.1%. This follows similar interventions by central banks in other countries and the RBA has recently indicated that its share of Australian government bonds will increase to 30 per cent by September 2021[6]. The RBA also reports that its interventions in longer-term government bonds have reduced the yield on 10-year government bonds by approximately 30 basis points[7]. These interventions are expected to have a prolonged effect on government bond yields.

Similar to the convenience yield, characteristics that are exclusive to prevailing government bonds are not representative of the rate of return required on a zero beta asset in the CAPM. That is to say these RBA interventions impact the return on government bond yields specifically rather than the required return of all equity. We therefore suggest the AER give further consideration to this issue and

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[5] IPART, Review of our financeability test, November 2018, pp. 13-14

[6] RBA, Statement of Monetary Policy, May 2021, p. 46

[7] Debelle, G., Monetary Policy During Covid, Shann Memorial Lecture, RBA, May 2021, p. 14

whether adjustments are required to government bond yields in light of the convenience yield and RBA interventions.

MRP

As aforementioned, the AER intends to re-evaluate the relationship between the risk-free rate and MRP as part of the equity workstream. In the 2018 RORI networks submitted that market evidence suggests the cost of equity is more stable over time than would be implied by one-for-one variation with changes in the risk-free rate. Despite this the AER concluded a Historical Excess Returns (HER) estimate, which is effectively constant over time, that varies one-for-one with changes in the risk-free rate was appropriate. This approach has resulted in historically and internationally low allowed returns in recent AER determinations.

We note the AER intends to reconsider its previously held position following advice from Dr Lally[8] and Brattle that the overall rate of return is unlikely to fluctuate one-for-one with the change in risk-free rate. In reviewing the MRP, the options before the AER are to set a constant MRP for the duration of the RORI period or to adopt an approach whereby the MRP is updated mechanistically during the RORI period at the time of each determination.

In reviewing the relationship between the MRP and risk-free rate we would urge the AER to have regard to the broader recommendations of Brattle. This would involve identifying options to incorporate more forward looking evidence into its estimation of the MRP such as the use of Dividend Growth Model (DGM) estimates and ensuring there is internal consistency in the final cost of equity estimate. In practice, the latter means that if the HER approach remains the preferred option for estimating the MRP, it would be inconsistent to then adjust the MRP for movements in the risk-free rate during the RORI period. This is because the HER estimate is effectively constant and independent of the level of the risk-free rate.

In considering the MRP and risk-free rate relationship the AER is non-committal on whether the relationship is procyclical or negative (i.e. whether the MRP increases or decreases when bonds yields increase or decrease). Whilst it is important to be balanced in general, it not even-handed to assign weight to evidence that is of questionable relevance or contrary to an established academic, regulatory and market consensus. On this matter, the literature cited by the AER (Damodaran, Li and Kim and Lee) provide little support for a positive relationship when taken as a whole and the conclusions therein are not formed in the context of the CAPM framework or use of the HER approach to estimating the MRP.

There is an overwhelming amount of evidence and regulatory precedent in support of a negative relationship. The evidence suggests the returns required by equity investors are more stable than is currently implied by adding a constant MRP to the prevailing government bond yield. To adopt a negative relationship would increase the volatility in the allowed return on equity. This would be contrary to the long term interests of customers at a time of significant technological change and we would suggest that the consideration of a procyclical relationship would be counter-productive. That is to say it is not the direction of the relationship but a reliable means by which to quantify it and mechanistically update a forward-looking MRP for it, that would be a more appropriate focus of future working papers.

If you have any queries or wish to discuss our submission further please contact myself on [redacted] or [redacted], Regulatory Strategy Manager at Endeavour Energy on [redacted] or via email at [redacted].

Yours sincerelv

[redacted]

Chief Financial Officer

[8] Dr Lally notes that the AER's estimate of the MRP is very stable over time and that the true value is likely to fluctuate meaning the MRP is likely to be underestimated during unfavourable market conditions. Dr Lally makes this observation noting that it does not necessarily invalidate the AER's past or current approaches.