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General Manager
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Email:

Dear

PATHWAY TO RATE OF RETURN 2022 – TERM OF THE RATE OF RETURN, RATE OF RETURN AND CASHFLOWS IN A LOW INTEREST RATE ENVIRONMENT

Energy Queensland Limited (Energy Queensland) welcomes the opportunity to comment on the Australian Energy Regulator's (AER's) draft working papers on the term of the rate of return and rate of return and cashflows in a low interest rate environment. We continue to support the AER's early engagement with stakeholders on key rate of return issues in the lead up to the formal 2022 Rate of Return Instrument (RoRI) development phase.

Energy Queensland is a member of Energy Networks Australia (ENA) and endorses the comprehensive submissions from the ENA. We also wish the make the following comments on the aforementioned draft working papers.

Term for the rate of return

Energy Queensland agrees with the AER that the term for expected inflation and term for rate of return should be independently assessed. Furthermore, the term for the return on equity (or the risk-free rate) and the term for the return on debt should also be separately assessed. This is largely consistent with past practice.

Despite the recent change to the term for expected inflation, from 10 years to five years, in the AER's 2020 Inflation Review, Energy Queensland considers that a 10 year term should be maintained for both the return on equity and return on debt. Energy Queensland disagrees with the AER's preliminary views, set out in the draft working paper, to match the term for the return on equity to the length of the regulatory period and possibly shorten the term for the return on debt.

The impetus for the AER's 2020 Inflation Review and the rationale for changing the term for expected inflation do not apply to the rate of return. In the AER's 2020 inflation review, it was evident that the AER's previous method for estimating expected inflation had been unreasonably overestimating expected inflation for a lengthy period. Thus, amendments were necessary. The term for expected inflation had to be changed to five years to ensure that the revenue that was being deducted from the post-tax revenue

model (PTRM) (i.e. the allowed return expected to be received via indexation of the regulatory asset base (RAB)) matched the amount of indexation that was expected to be added to the regulatory asset base (RAB) in the roll-forward model. A five year term for expected inflation ensured that the ex-ante returns were appropriate.

There is no evidence that network businesses have been overcompensated since the 2018 RoRI, when the AER materially cut the equity risk premium and yields on 10 year Commonwealth Government Securities subsequently declined to historical lows. On the contrary, a case can be made that current returns for network businesses are unsustainably low. Indeed, the Brattle Group Report observed that the returns on equity for Australian network businesses regulated by the AER were the lowest amongst comparable regulators in the world.[1] In this context, it is concerning that the AER is contemplating making changes to the term for the rate of return that will potentially further reduce the rate of return and network revenues.

The Australian Competition and Consumer Commission (ACCC) and the AER have consistently applied a 10 year term for the return on equity since the 2003 GasNet Tribunal decision. Since that decision, the AER has extensively considered the issue of the term for the risk-free rate in the three successive rate of return reviews (2009, 2013 and 2018). In these reviews, the AER held that there were reasonable arguments in support of both a five year term and a 10 year term. The primary argument in support of a five year term is the net present value equals zero principle (NPV=0) that has long been advocated by Dr Martin Lally and Professor Kevin Davis. On the other hand, support for a 10 year term is based on the long-lived nature of the underlying assets. The AER has previously used its judgement to rule in favour of the latter. It is also worth noting that use of 10 year term (or longer) is the predominant approach of jurisdictional and international regulators.

However, the AER's draft working paper states that, now, the AER's preliminary view is that a five year term is more appropriate. We note that no new evidence or developments in academic literature, finance theory, market practice or other regulators' practice have triggered the AER's preliminary view. In fact, the most recent change in relation to the term for the return on equity has been the Queensland Competition Authority moving away from the previous practice of matching the term of return on equity to the regulatory period and adopting a 10 year term. The draft working paper outlines the same material and key arguments that were considered extensively by the AER in previous reviews before it adopted a 10 year term.

The only change in the current review is that the AER is seeking to elevate the NPV=0 condition as its key criterion based on an 'evolution in its thinking.' The AER further suggests that the 'same set of evidence, when assessed by different regulators at different points in time, can potentially lead to different conclusions'. Energy Queensland does not consider that the AER's considerations in relation to the term of the risk-free rate are consistent with promoting certainty and predictability in decision making.

In our view, the AER's role is to estimate the return on equity required by real-world investors. This is the return on equity that will contribute to the achievement of the National Electricity Objective and National Gas Objective. Market practice, which is to use a 10 year term, should therefore inform the AER's task. We submit that a 10 year term for the return of equity should be maintained.

[1] Brattle Group, June 2020, A review of international approaches to regulated rates of return.

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In relation to the return on debt, industry data on the weighted average term at issuance (WATMI) indicates a term ranging from eight to 11 years. This suggests that the current 10 year term for the return on debt remains appropriate. Moreover, given that all network businesses are still transitioning to a 10 year trailing average, changing the term would necessitate further complex transitional arrangements.

Rate of return and cashflows in a low interest rate environment

It is indisputable that we have been in a low interest rate environment for several years. Global interest rates declined to near zero and have been persistently low following the 2008 global financial crisis. Energy Queensland acknowledges and supports the AER's agreement that we are in a low interest rate environment.

With interest rates remaining persistently low for an extended period, Energy Queensland submits that the AER should holistically revisit its approach to setting the return on equity in the 2022 RoRI, and in particular, both the estimation and relationship of the risk-free rate and market risk premium (MRP) in the Sharpe-Lintner Capital Asset Pricing Model (SL-CAPM). We thus support the AER committing to deeply explore the relationship between the risk-free rate and MRP in the 2022 RoRI. We do not consider that it is reasonable that the return on equity varies one-for-one with the risk-free rate, which has been the AER's approach to date.

However, in addition to considering the relationship between the risk-free rate and MRP, we also strongly urge the AER to revisit the estimation approaches for the values of these two parameters. This includes reconsidering whether Commonwealth Government Securities are an unbiased proxy for the risk-free rate. The draft working paper states that this a firm view of the AER. Nevertheless, in light of the unprecedented intervention of the Reserve Bank of Australia in the bond markets, with the objective of keeping bond yields artificially low, the AER should re-evaluate this view.

In relation to the MRP, we continue to submit that is important that the AER has regard to a broader set of evidence and particularly forward looking evidence. The AER's reliance on historical excess returns, which produce a largely constant MRP, clearly does account for changes in the economic environment.

Finally, we submit that financeability tests are good regulatory practice. Many regulators have regard to financeability tests when evaluating their decisions. The AER has consistently stated that estimating the rate of return is a complex task. For instance, the required return on equity is unobservable and a fair degree of judgement is required. Within this context, Energy Queensland believes it is reasonable that financeability tests must be part of the regulatory tool-kit used, at a minimum, to test whether the regulator's judgements are internally consistent. This is especially pertinent in the current low interest rate environment where recent AER decisions have projected negative net profits after tax in the PTRM.

We accept that businesses can undertake a range of measures to address financeability issues including deviating from the AER's benchmarks. However, this should generally on apply in exceptional circumstances such as when a business is required to undertake a relatively large capital expenditure program. An efficient firm with a steady-state capex program should not be required to deviate from the AER's benchmarks in order to finance its activities.

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Should you wish to discuss any aspect of this matter further, please contact [redacted] [redacted] on [redacted].

Yours sincerely

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