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Mr Scott Sandles
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Submission regarding the Rate of return guidelines – Consultation paper from May 2013

RARE Infrastructure is pleased to provide feedback on the Rate of return guidelines Consultation paper which forms a part of the AER's Better Regulation programme. We welcome the thorough and open way in which the AER has been conducting this review, and believe that an ongoing dialogue with stakeholders including investors is essential to ensuring a robust and sustainable regulatory framework in the interests of customers, companies, and investors.

RARE Infrastructure is a specialist investor in listed infrastructure securities. Our brief comments here and contributions through the process therefore reflect our experience of analysing and investing in energy networks and other regulated industries across the world. There are three overarching observations on the guidelines that we would like to make.

First, as a global investor we choose where to invest on the basis of the balance of risk and return compared to opportunities elsewhere. Quite rightly, the review focuses on the technical aspects of cost of capital estimation. But the success of the final cost of capital guidelines will be determined by whether the framework provides attractive returns to investors in the Australian energy networks in the context of other opportunities elsewhere. Final judgments by the AER on the framework should have regard to this.

Second, while the allowed return and the associated methodology for determining are very important, as investors we look at this in the context of the overall package of a regulatory determination. This includes incentive arrangements and the prospect for a company through good management to earn superior returns for shareholders provided that they meet the needs of their customers. This consideration may go beyond the precise terms of reference of the cost of capital workstream, but it is important, and consideration of this may allow the overall framework better to meet the needs of all stakeholders.

Third, we welcome the introduction of a greater measure of judgment into the framework rather than a more formulaic approach. We believe that the focus of cost of capital estimation should be on getting the answer right for all stakeholders, avoiding the risks associated with the requirement to use a single methodology. From an investor's perspective, stability of equity returns and dividends paid out is more important than certainty of the model being applied. The previous rules delivered some mechanical certainty in terms of knowing how the parameter estimates would be combined together, however the resulting WACC and CoE was highly sensitive to spot bond yields (so there was no certainty of allowed returns). A more stable Return on Equity would enhance clarity for all investors, and boost the desirability of Australian network businesses in the global investment universe (leading to lower cost of capital, which is in consumer interests).

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For this reason, of the four potential approaches to Return on Equity models (described in Section 5.5, from pages 42-44 of the Consultation paper):

- Using a single model (ie Option 1) is overly simplistic and can result in volatile outputs… (see the comments above);
- Option 2 is preferable to Option 1;
- Option 3 is transparent in terms of weightings, but justifying these could be demanding; and
- The strongest method appears to be Option 4, drawing on a wider range of models. We note, however, that it demands a comprehensive approach from the regulator (in the spirit of AEMC rule changes).

Other observations we have are:

- We were surprised at the 4 June 2013 workshop that the Sharpe-Lintner CAPM appeared to be adopted as the sole acceptable model, while other models were downplayed and only four other models were considered;
- Given the long asset life of T&D networks (much longer than 5 years on average), having a longer term for debt and equity costs will more closely match assets to liabilities. Hence, we support longer-term measures of the Risk Free Rate (10 years plus, rather than 5 years);
- Flexibility should be adopted for debt costs, particularly noting the ability of small network to completely refinance during the measurement window but the inability for the largest networks to do this… The option should be in the hands of the Network Service Provider (NSP), so that the debt cost mechanism is compatible with their current debt portfolio and with the financing policies of the NSP;
- Consideration should be given to allowing Network Service Providers to choose between a revenue cap and a price cap, allowing them to best manage risks and to hedge costs against revenues more effectively;
- We suggest that there could be a role for reasonableness checks not just at the overall Rate of return level, but also for CoE/CoD/gearing and some of the input parameters for the various models; and
- When considering reasonableness checks, the data needs to be analysed and presented in a comparable form (eg for EV/RAB multiples by making appropriate adjustments for the non-regulated assets owned by the entity, and for variations between the carrying value and face value of debt on their balance sheet). Simply calculated measures provide a low-quality interpretation of valuation measures, such as the wide range between EV/RAB multiples from various brokers. Forward-looking multiples are preferable, since they compare the current equity value with expected earnings or cashflows in the future (as listed equity markets do in practice).

We would be happy to discuss these issues in more detail with the AER if this would be helpful.

Regards,
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