2 July 2021

[redacted]
General Manager, Network Financing and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Email: [redacted]
Copy: [redacted]

Dear [redacted],

Submission in response to the AER's working papers on *Term of the Rate of Return* and *Rate of Return and Cashflows in a Low Interest Rate Environment*.

Thank you for the opportunity to provide a submission to this stage of the AER's process in relation to the 2022 Rate of Return Instrument (**RoRI**).

This submission has been prepared by Australian Gas Infrastructure Group, SA Power Networks, United Energy, CitiPower and Powercor (**the businesses**). We strongly endorse the AER's approach of commencing consultation on the 2022 RoRI, and look forward to actively engaging in the consultation process with the AER and other stakeholders.

The focus is on the long-term interests of consumers

The NEO and NGO are centred around the long-term interests of consumers. On this point, the businesses endorse the ENA submission on *Allowed Returns in a Low Rate Environment*, which explains why the long-term interests of consumers are best promoted by setting the regulatory allowance for the return on capital equal to the best possible estimate of the market cost of capital.[1] We note that the AER has reached the same conclusion in its recent paper on this topic.[2]

The businesses also agree with the AER's observation that what is required is the best possible estimate at the time of each decision. It is not sufficient that the regulatory allowance be unbiased over the long-run[3] as this would result in some generations of consumers paying more than the efficient cost and others paying less.

That is, the long-term interests of consumers are best served by setting the regulatory allowance to reflect the efficient cost of debt and equity finance required by real-world investors at the relevant

[1] *See particularly Section 2 of that submission.*
[2] *AER, May 2021, Assessing the long-term interests of consumers. See particularly pp. 2, 8.*
[3] *AER, October 2020, Inflation Review Final Decision, p. 19.*

time. This approach creates the proper incentives for efficient investment in, and efficient utilisation of, network assets over time.

Consumers will benefit from substantial investment over the next decade

Consumers of the future will engage with networks in different ways, expecting networks to be ready to support the investments that they want to make behind the meter in relation to the generation, and smarter use, of energy. In addition, networks will invest a significant amount of capital to support Australia's transition towards a lower-emissions energy sector. It is these new types of investments to which we must now look, and the incentives that support their timely deployment.

The sorts of new investment that will likely be required include:

- Connecting renewable generation to the existing grid;
- Augmenting the existing grid and building smart grid technology to accommodate increasing DER and to enable full support of the significant behind-the-meter investment currently being undertaken by customers;
- Building network resilience including large-scale asset replacement programs in aging networks; and
- Integrating hydrogen assets into gas networks (e.g., enabling consumers to invest in hydrogen production such that gas networks can be used as Australia's largest battery).

These investments will simultaneously improve safety and reliability, lower prices, allow customers to optimise the benefits of their own behind-the-meter investment and support government policy to transition to a low emission future.

Allowed returns are currently out of step with other regulators and market evidence

It is not clear whether the allowed rates of return stemming from the 2018 RoRI will be sufficient to provide incentives for this new investment in a timely fashion. In recent times, Australian government bond yields have fallen to historical lows – below any level observed since WWII. Under the 2018 RORI, this results in a lock-step change to the allowed return on equity which is now at historic lows. There is mounting evidence that the current approach has delivered results out of step with regulatory practice and market evidence. As the AER has noted, this raises questions about whether the current approach to the allowed return on equity gives the best possible estimate of the market cost of capital and is in the long term interests of consumers, or whether, other approaches should be considered that give rise to an allowance which is more robust to fluctuations in bond yields.

The AER recently commissioned the Brattle Group to consider the approaches adopted by other comparable regulators and to make recommendations for potential improvements to the AER's process. [4] The Brattle Report identifies that:

- The AER's allowed return on equity is lower than that adopted by every other regulator for which a comparison could be made; and that

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

- The AER's approach to the allowed return on equity "is not as effective as the approach of other regulators"[5] such that the AER should consider a number of areas for reform.

The businesses endorse the ENA submission on this point,[6] which identifies a number of features of the AER's current approach that drive the current low regulatory allowance. We consider it to be important that, throughout the 2022 RoRI review, stakeholders engage fully with the Brattle material, conclusions and recommendations.

It is particularly important to ensure that the allowed return reflects the market cost of capital (to ensure that the appropriate incentives are restored) in light of the investment that is required over the next decade.

Low regulatory allowances are already impacting investment

There is some evidence emerging that low rates of return are slowing, or curtailing investment incentives within our businesses.

Some businesses have not yet experienced these reductions and others have only experienced them recently – depending on the timing of regulatory determinations. But we are already seeing an impact on investment, which are troubling early signs. For example:

- The AGIG Mt Barker expansion will not proceed because it is not economically viable given the current level of allowed returns; and
- Project Energy Connect would not have proceeded without the $295 million of government-subsidised funding provided by the CEFC.

In some cases, the regulatory allowance has been extreme. For example, SA Power Networks receives a real return on equity of 2.21% (and even less if actual inflation turns out to be lower than the AER's forecast) and will generate a loss (NPAT) in its PTRM of $135 million over its 5-year regulatory period which will have to be 'made up' by future consumers. There is no feature in the current regulatory approach to prevent these, or even worse, outcomes from occurring in the future. Improving robustness against these kinds of unforeseen outcomes, rather than hoping rates will not drop so low again, is a key task of this review.

A constructive way forward

The businesses do not suggest that allowed returns should be 'aimed up' to provide a special incentive to encourage investment – just a matching of the regulatory allowance to the returns that investors currently require to provide capital for investment.

We agree with the AER that the NEO and NGO, and the long-term interests of consumers, are best promoted by setting the allowed return on capital to match the market cost of capital at the relevant time. We are committed to working closely with our own consumers and with the AER towards a 2022 RoRI that achieves that objective.

The remainder of this submission briefly documents our views on the issues raised in the AER's recent *Term* and *Low Rates* working papers.

---

[5] *Brattle Group, June 2020, A review of international approaches to regulated rates of return, paragraph 217.*
[6] *ENA, 2021, Allowed returns in a low rate environment.*

The relationship between the risk-free rate and the market risk premium

The 2018 RoRI embeds an assumption that the required return on equity rises and falls one-for-one with any change in the prevailing government bond yield. Thus, the recent decline in government bond yields to historical lows has the consequence of also reducing the allowed return on equity to historical lows.

We note that concerns about this assumption were raised in 2018 and since. Some of these concerns are identified in the Brattle report and others in the ENA submission. The result of this approach is that the allowed return on equity is 'at the mercy' of whatever happens to government bond yields – whereas market practitioners, valuation experts, and other regulators take a different approach that produces more stable estimates of the required return on equity.

The AER is currently seeking input on how it might develop an approach to the allowed return on equity that is more robust to the sorts of events that have occurred since 2018. We look forward to working with the AER on this core topic of the 2022 review. Its resolution will require some new ways of thinking about how to set the allowed return on equity to ensure a better match to the market cost of capital across a range of potential market conditions. The starting point of this consideration is a discussion about how to relax the assumption of a one-for-one relationship between the allowed return on equity and the prevailing government bond yield. Brattle recommend having some regard to forward-looking evidence and the ENA submission also contains some recommendations.

A move away from the AER's current approach of adopting a fixed historical average MRP in all market conditions would also have the effect of reducing volatility in the allowed return on equity. Expanding the evidence that is considered to include forward-looking information would have the effect of increasing the MRP when rates are low and vice versa – producing more stability in the total return on equity.

Consumers would benefit in two ways from this:

- They would always pay only the efficient cost of the equity that is used to provide the service to them. This creates the proper incentives at all times for investment in, and utilisation of, energy networks; and
- They would experience lower volatility in the payments they make in relation to the return on equity.

We have commenced preliminary discussions with our customer representatives, and commit to working with our consumers to better understand:

- Whether there is a preference for each generation of consumers to pay the efficient cost of the service that is provided to them; and
- Consumer preferences for lower volatility in allowed returns.

Once a decision has been made about the process that will be used to estimate the MRP in the 2022 RoRI, consideration can be given to methods for updating the MRP during the life of the RoRI if required. For example, if the RoRI recognised that the MRP varied over different market conditions, it would make sense to adjust the MRP as market conditions changed over the life of the RoRI. By contrast, if the RoRI determined that the best estimate of the MRP is always the historical mean of6.1%, that same figure would be adopted throughout the life of the RoRI.

The businesses suggest that a key focus of the forthcoming *Return on Equity* consultation process should be on how the MRP will be estimated in the 2022 RoRI. This will then determine whether the

MRP should be updated (in an internally-consistent way) at the time of each determination conducted under that RoRI.

The term of the risk-free rate

The businesses support the current approach of adopting a 10-year term for the risk-free rate. That approach is consistent with market and regulatory practice and best represents the approach used in determining the market cost of equity.

We endorse the analysis and reasoning in the ENA submission[7] on this point and consider that this approach can be 'locked away' at this stage of the process. We caution against a change which has so little support in theory or in regulatory practice around the world.

The approach to the return on debt

The businesses support the current approach to the return on debt because it matches the regulatory allowance to the (efficient) market cost of debt.

We support the 10-year trailing average approach and endorse the analysis and reasoning in the ENA submission[8] on this point, and we consider that this approach can be 'locked away' at this stage of the process.

We particularly caution against an approach that adjusts the benchmark credit rating to reflect a perceived issue in relation to the term of debt. This would produce a regulatory allowance that could not be replicated by any network – it is not "viable" in the terms of Dr Lally.[9] It cannot be the case that a debt management approach that cannot be implemented in practice best represents the market cost of debt.

Financeability assessments

The businesses consider that a financeability assessment is a useful tool that is part of good regulatory process. The ENA submission[10] on this point explains how financeability assessments might be used as part of an early warning system in the regulatory process. We endorse the ENA's submission on this issue and note the importance of these kinds of cross checks in a setting where parameters cannot be precisely estimated and economic models cannot produce precise estimates of the true market cost of capital.

Financeability is critical to delivering acceptable credit metrics consistent with the achievement of the regulatory benchmark credit rating, particularly in a low return environment. Investor confidence in the regulatory process, including the ability to finance required investment is critical in allowing returns to stay low.

We look forward to engaging further with the AER and other stakeholders as the review proceeds. If you require any further information or would like to discuss this submission, please contact [redacted] on [redacted] or at [redacted].

---

[7] *ENA, 2021, The term of the rate of return.*
[8] *ENA, 2021, The term of the rate of return.*
[9] *Lally, April 2021, The appropriate term for the allowed cost of capital, p. 25.*
[10] *ENA, 2021, Allowed returns in a low rate environment.*

Yours sincerely,

[redacted]

[redacted]
Executive General Manager Governance and Regulation
South Australia Power Networks

[redacted]

[redacted]
General Manager -Regulation
CitiPower, Powercor and United Energy

[redacted]

[redacted]
Executive General Manager – Corporate and Regulation
Australian Gas Infrastructure Group