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Mr Warwick Anderson
General Manager Network Finance and Reporting
Australian Energy Regulator
GPO Box 520
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Dear Warwick

Pathway to the 2022 Rate of Return Instrument: Consultation Paper

I refer to the above consultation paper and welcome the opportunity to respond on behalf of the Australian Gas Infrastructure Group (AGIG). We commend the AER for starting their consideration of the 2022 process early, providing plenty of time to ensure that the process is well-planned and efficient. This should provide opportunities for further improvement over the 2018 process. We also provide some responses to the December rate of return update, as requested by the AER.

AGIG has worked with its two representative bodies, Energy Networks Australia and the Australian Pipelines and Gas Association, and endorses the comments and recommended review process enhancements in their respective submissions. This submission highlights some key points relating to:

- The AER's use of concurrent evidence sessions;
- The independent panel process; and
- The assessment and treatment of evidence.

Concurrent evidence and the independent panel

The concurrent evidence sessions and the independent panel were both opportunities to bring additional expertise to bear and improve the quality of the AER's decision in 2018 and stakeholder confidence in the decision. We believe both were positive developments from 2013. However, like all new developments, improvements are possible. In particular:

- Little distinction appears to have been made in the sessions between evidence and the opinion of the expert. The experts were not subject to any of the formalities that would normally apply to expert evidence given in a hearing, such as the Federal Court Guideline for expert witnesses. In its November paper, the AER does not appear to be proposing any change to that approach (see, for example, p15). Enhancing the rigour around the concurrent evidence sessions (for example, requiring experts to identify assumptions relied on, differentiate between evidence and opinions, identifying limitations or qualifications on opinions and where opinions differ materially from previous opinions expressed by the expert) may allow the AER to place greater weight on the outcomes of the concurrent sessions and would increase stakeholder confidence in the review process.

- In relation to expert reports relied upon by the AER, we note that in a number of cases the AER obtained reports from experts on topics similar to those discussed in the concurrent sessions shortly after those sessions had occurred. Several stakeholders commented on how this reduced confidence in the review process. The AER has discretion as to the expert reports it obtains, but we suggest it would increase confidence in the process if expert reports were obtained prior to the concurrent sessions occurring. The concurrent sessions can then be designed to explore the matters raised in all relevant topics. Further, making experts available to discuss and provide views on all issues within their area of expertise, rather than just the areas covered in their reports would arguable lead to better, more reliable outcomes from this process.
- The expert joint report which followed from the concurrent sessions, perhaps for reasons of timing, had limited utility. It contained mostly a series of dot points summarising expert views, but without

substantially reducing areas of contention, identifying areas of agreement, etc. With a little more time and formality around the process, and greater input by the experts themselves, the joint report would be a more useful resource for the AER in its own deliberations.

- In the Brattle report, several stakeholders expressed concern with the way in which the AER made use of evidence from the concurrent sessions, pointing out, for example, that the AER appeared to be following the minority view, or even suggesting that experts might have formed different views if more time had been available. Without seeking to constrain the AER's discretion under the National Gas Law, one way of addressing this would be to develop a standard by which all evidence is assessed and to clearly and transparently explain why the AER has taken a particular view by reference to that standard. This should include the AER making clear what evidence it has relied upon that the experts have not, and why it is more compelling. A similar standard in respect of the independent panel report would likewise assist in improving confidence by allowing stakeholders to see more clearly the AER's reasoning.
- We fully support the ENA submission that the suggestion in the November 2019 consultation paper that holding the concurrent evidence sessions without stakeholders present would undermine transparency and confidence in the process.
- We believe the independent panel should not be limited in its review to just issues of process. The expertise of the independent panel can be far better utilised and contribute to a better overall outcome if substantive issues rather than just process are considered. In particular, the Panel should not be limited to considering whether the decision is *capable of* meeting the NGO/NEO, but rather required to consider whether it *best* meets the NGO/NEO. It is then a matter for the AER to have regard to the independent panel's comments and views in exercising its discretion.
- In respect of the independent panel, stakeholders expressed concern that the panel may not have considered all submissions. The AER also expressed concerns that stakeholders not be able to provide new information to the panel. These concerns could be addressed by allowing stakeholders to provide for the panel a short, clearly reasoned summary of what they consider to be key issues.

Assessment of the evidence

As the ENA submission points out, ensuring that decisions promote the NGO requires decision making which is independent and based on a balanced consideration of the best available evidence. The treatment of evidence, changes in approach and transparency of reasoning were key issues in responses in the Brattle report. These concerns need to be addressed through substantive changes, rather than just extending the same process, to ensure stakeholders can have confidence in the 2022 process. We encourage the AER to continue to engage with stakeholders on measures considered necessary to ensure confidence in the process, and to look at best practice methods of doing so as part of its working paper process.

Broad stakeholder ownership of this aspect of the 2022 instrument will be very important to achieving this outcome. In that spirit, we present some ideas below which we consider may be of assistance:

- The AER could define a set of assessment criteria for all evidence put to it which ensures balance and a fair treatment of the evidence.
- Where empirical evidence is put forward it should not be rejected because of issues which might exist in the empirical evidence. Rather, these potential issues should be subject to verification in the actual data used in the empirical analysis, and, if they do exist, their impacts should be assessed for materiality. This is not to suggest that empirical evidence needs to be accepted unless it can be conclusively proven to be wrong, but rather that the standard for reducing weight or reliance on empirical evidence should be higher than has been the case in the past.
- Evidence which is capable of being tested by data should be given greater weight by the AER than assertions based on non-testable propositions or theoretical constructs.
- Where cross-checks are used, stakeholders should agree early in the process, and before the analysis is undertaken, how an outcome could fail cross checks, and what the consequences for that outcome ought to be if it does fail.

December rate of return update

The AER has also asked for comments on the December rate of return update. Again, we defer to the submissions from the Energy Networks Association and Australian Pipelines and Gas Association for detailed responses. We believe that updating the data is a useful exercise, but could be enhanced in several ways:

- There is very little context around the updated numbers and what changes might mean. At a minimum, it would be useful for stakeholders if the AER could reiterate how the evidence was used in 2018, including the weight the evidence was given. As more data becomes available, it would be useful if the AER could also make some preliminary observations on how it is viewing various pieces of evidence and any emerging trends.
- It may be useful for the AER to fine-tune what it reports on. For example, given that surveys were given little weight in December 2018, and it appears that only one survey has been updated, it is not clear whether reporting on this is helpful to stakeholders. By contrast, the AER made use of several cross checks in 2018, but only updated one. It may be useful to update all cross checks, and for the AER to suggest new ones via its working paper process).

We also share the views of the industry associations that some additions to the update might provide some useful context for stakeholders, in particular:

- An update to financeability; it remains our view that financeability is a critical part of the rate of return review process. We are concerned that almost a third of the benchmark efficient entities were unfinanceable based on the AER's own analysis. In our view this is a strong indicator that the outcome of the rate of return process was not consistent with the achievement of the NGO, because the BEE is unable to raise sufficient funds to undertake efficient investment. It would be highly useful for many stakeholders to understand whether this situation has improved heading into 2022.
- An indication of the real return implied by each update to the allowed rate of return. The AER targets a real rate of return, and we think it would be useful for the AER to make explicit in its updates the real rate of return it is implicitly targeting with the updated nominal allowed rate of return. We also think it would be useful for stakeholders to be able to have some points of comparison, where feasible, which we detail below.

Although there are no measures of the real expected return on equity, there are a small set of indexed corporate bonds in Australia which, just as nominal corporate bonds give a market view of the nominal expected return on debt, provide an indication of the real expected cost of debt. Although they are arguably too few for the AER to use to derive the allowed cost of debt, they could be used to provide an ongoing "sense check" of the real return on debt which the AER is targeting.

As a final point, we note that the AER is currently undertaking a review of the issue of inflation, which it last addressed back in 2017. We are pleased to be an active participant in that process. Whilst we do not necessarily think that the AER should follow the lead of, say, the ERA, and include inflation as one of the things considered as part of the rate of return instrument, we do think it would be useful for the AER to consider the interaction of its inflation and rate of return conclusions.

By way of an example, for the month of November, we calculate the AER's 2018 instrument nominal cost of debt allowance at 2.83% and the AER's inflation estimate as 2.29%. Using a standard Fischer equation, this suggests a real cost of debt of 0.53%. However, there are indexed corporate bonds available in the Australian marketplace and the real yields to maturity they provide at the end of November (sourced from Bloomberg) appear to be higher than the AER's implied real cost of debt.

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Table 1: Returns on indexed corporate bonds

Issuer Name	Ticker	Maturity	Rating (S&P/Moodys)	Maturity Type	Yield mid	Yield offer/bid
Sydney Airport Finance Co Pty Ltd	SYDAU	20/11/2020	BBB+	Capital Indexed Bond	0.97	1.04 / 0.904
ALE Finance Co Pty Ltd	ALEFC	20/11/2023	AAA	Capital Indexed Bond	0.57	0.613 / 0.533
Australian Gas Networks Ltd	ENVAU	20/08/2025	A+	Capital Indexed Bond	1.23	1.262 / 1.195
Plenary Health Casey Finance Pty Ltd	PHF	15/09/2029	A2	Indexed Annuity	1.42	1.447 / 1.384
Australian National University	ANU	7/10/2029	AA+	Indexed Annuity	1.02	1.117 / 0.929
Sydney Airport Finance Co Pty Ltd	SYDAU	20/11/2030	BBB+	Capital Indexed Bond	1.61	1.637 / 1.587
JEM NSW Schools II Pty Ltd	JEMNSW	28/02/2031	A1	Indexed Annuity	1.41	1.445 / 1.375
Axiom Education Pty Ltd	AXIOM	30/12/2032	A2	Indexed Annuity	1.34	1.477 / 1.203
Rembrandt Australia Trust	RAT	23/01/2033	A-	Indexed Annuity	2.05	2.248 / 1.86
Ancora OAHS Pty Ltd	ANCORA	27/06/2035	A+	Indexed Annuity	1.86	1.883 / 1.833
JEM NSW Schools II Pty Ltd	JEMNSW	28/11/2035	A1	Indexed Annuity	1.58	1.609 / 1.559
University of Wollongong	UOW	23/12/2035	Not Rated	Indexed Annuity	1.67	1.697 / 1.638

Even though most have a tenor much shorter than ten years, and many have credit ratings higher than BBB+, all (save for the AAA rated, four-year ALE Finance bond) have real yields to maturity much higher than the real yield to maturity the AER considers is implicit in its nominal cost of debt allowance. This appears incongruous, and it is not clear, if the AER's real cost of debt allowance is correct, why investors have not bid up the prices of the bonds in the table above. The result may be an anomaly associated with the time-frame under consideration, but we believe that the cross check would be a useful addition to the AER's annual update to allow readers to glean more meaning from the statistics presented.

Should you have any queries in respect of the above, please contact Nick Wills-Johnson [redacted] or myself. Once again, we look forward to working with you during the process to 2022.

Yours sincerely

[redacted]

Craig de Laine
GM – People and Strategy