AUSTRALIAN ENERGY REGULATOR

Our Ref: 65402
Contact Officer: Warwick Anderson
Contact Phone: [redacted]

Level 17, Casselden
2 Lonsdale Street
Melbourne Vic 3000
GPO Box 520
Melbourne Vic 3001
tel: [redacted]
www.aer.gov.au

26 August 2022

Dr Steven Kennedy
Secretary
Treasury

Dear Dr Kennedy,

AER review of the Rate of Return Instrument and impacts of monetary policy post the Global Financial Crisis on asset prices

I am writing to seek your views to inform the Australian Energy Regulator's (AER) upcoming decision on the rate of return for the energy networks we regulate.

We recently published our Draft decision on a new Rate of Return Instrument (RoRI) under the National Electricity and National Gas Laws. This new RoRI will replace the first RoRI made in 2018. We will publish the Final new 2022 RoRI in mid-December this year. We had an Independent Panel of experts review our draft decision and they have recommended we seek advice on how monetary policy has impacted the underlying data we rely on for determining our rate of return. I would be very grateful for any assistance the Treasury could offer, if possible, by late September, to input into our final RoRI decision later this year.

The RoRI formulaically sets out how we will calculate the return on capital for the energy networks we regulate. In calculating the rate of return in the Draft RoRI, we:

- Use the Capital Asset Pricing Model (CAPM) to calculate a return on equity, and
- Set the market risk premium (MRP) values associated with different investment periods to use in the CAPM's application.

In setting the MRP values used in Draft RoRI we:[1]

- Used an arithmetic average of annual calendar historical returns on the Australian All Ordinaries Index in excess of the annualized yield to maturity on Commonwealth Government securities (CGS) of an appropriate maturity, and
- Primarily relied on the return in calendar years from 1988 to 2021 (34 annual observations).

We refer to this approach, as the Historical excess returns (HER) approach to estimating the MRP.

Our estimates of average excess returns increased materially relative to our estimates used in making the first RoRI in 2018. For example, the estimate of the Australian ten-year term MRP increased from 6.1 per cent in 2018 to 6.5 per cent in 2022.

---

[1] This methodology is discussed in the explanatory statement to the Draft 2022 Rate of Return Instrument – Explanatory Statement – 16 June 2022 at pp 128-134.

The Independent Panel, in its report, raised the question of whether the high returns in the years from 2018 to 2021 should be reflected in our MRP estimates, or whether they were "unexpectedly excellent years for the equity market relative to bond yields" and therefore tell us little about the long-term average MRP.[2] In this context, the Independent Panel stated:[3]

> In considering possible sources of variation in the long-term market risk premium, it would be useful for the AER to access advice on whether the returns on financial assets in the post global financial crisis period were influenced by quantitative easing and whether this may have contributed to an upwards bias to the HER-based estimate of the MRP. From a forward-looking perspective, the unwinding of excess liquidity caused by quantitative easing has the potential to progressively lower the MRP. The Panel believes that analysis of these issues, could provide a useful addition to the information previously considered by the AER.

Two recommendations of the Independent Panel were the AER:[4]

> Seeks expert advice on the implications of central bank liquidity expansion (following the onset of the Global financial crisis and during the COVID-19 pandemic) on the valuation of financial assets and the implications that this may have for historical excess returns (HER) based estimates of the long term MRP.
>
> Seeks expert advice on the potential implications of the normalization of central bank balance sheets for future valuations of financial assets and the associated implications for HER-based estimates of the MRP.

In light of the Independent Panel's recommendations above, we would be grateful for any advice on the questions directly above including whether:

- monetary policy, including quantitative easing, may have contributed to an upward bias in our HER based estimates over the period from 1988 through to 2021.
- the movement of monetary policy to more usual settings, including the unwinding of excess liquidity caused by the quantitative easing, has the potential to progressively lower the estimate of MRP derived from historical excess returns
- the Treasury has identified a change in the equity market risk premium in Australia from late 2018 to now
- the Treasury has any other views or information that it considers relevant to the estimation of the market risk premium using historical excess returns.

Given our timeframes for finalising the new RoRI, if possible, we would request a response by no later than 30 September 2022.

We greatly appreciate any assistance the Treasury can give us with this request. For any questions, or to discuss this request, please contact Warwick Anderson on [redacted] or at [redacted]. We have written to the Reserve Bank of Australia with the same questions and our contact is Mr Chris Kent Assistant Governor (Financial Markets).

Yours sincerely

Clare Savage
Chair
Australian Energy Regulator

---

[2] Independent Panel, Independent Panel Report: AER Draft Rate of Return Instrument, p27.
[3] Independent Panel, Independent Panel Report: AER Draft Rate of Return Instrument, p28.
[4] Independent Panel, Independent Panel Report: AER Draft Rate of Return Instrument, p29.