Australian Gas Infrastructure Group
L6, 400 King William Street
Adelaide, SA 5000 Australia
PO Box 6468, Halifax Street,
SA 5000 Australia
+61 8 8227 1500
info@agig.com.au
agig.com.au

2 September 2022

Warwick Anderson
General Manager | Network Pricing
Australian Energy Regulator
GPO Box 3131
Canberra
ACT 2601

Dear Warwick,

Thank you for this opportunity to respond to the AER's draft rate of return instrument, and provide feedback to assist in improving the final instrument due in December. AGIG supports the submissions of both the Energy Networks Association (ENA) and the Australian Pipeline and Gas Association (APGA) and refers the AER to those submissions for the further details associated with the points we make below.

In respect of the cost of debt, gamma and gearing, we have no concerns with the conclusions reached in the Draft RoRI. We therefore focus on the three elements of the cost of equity; the market risk premium, beta and the term of the risk-free rate.

Of these, it is the term of the risk-free rate which causes us greatest concern. This is not because of the numerical difference in allowance which follow from the AER's change in approach, but rather the chain of logic which has apparently led the AER to overturn 20 years of its practice and adopt the five year government bond rate as the risk free rate proxy. This logic, we believe, has two fundamental flaws, which appear to be inter-related:

- Firstly, whilst the AER understands that the ten-year government bond is widely used by investors as the risk-free rate proxy, the AER's approach is to ignore what investors actually do in favour of what they should do if the assumptions underpinning Dr Lally's model were true. Quite apart from the major problems with this model (see the expert report by Professor Richard Schmalensee submitted by the ENA), if the AER provides an allowance which differs by design from the rate of return required by investors, the result, when investors discount the relevant cashflows, must be an NPV-negative outcome for them; unless they too adopt the mathematical model the AER favours. Such an approach cannot lead to efficient investment incentives.
- Secondly, the AER appears to believe that the price resetting process drives exposure to one key systematic risk, interest rate risk, rather than the time over which invested capital is exposed to that risk. As the ENA point out, this is in direct contradiction to basic finance theory and, as the Queensland Treasury Corporation show empirically, it is not borne out in reality. We would add that, if the AER's view were correct, firms able to set their prices with regulatory oversight could lower their cost of capital simply by changing their prices more frequently. This is not only self-evidently untrue in practice, but runs counter to the theoretical framework of the CAPM, which underpins the AER's approach to equity.

A change in practice based on these errors is likely to undermine confidence in the regulatory framework and will not encourage efficient investment. It also appears likely to lead to some perverse outcomes which do not appear to have contemplated by the AER and which are discussed in the APGA and ENA submissions. We would urge the AER to reconsider its departure from past practice on this point as it formulates its final RoRI.

In respect of the market risk premium, the AER favours a fixed, unconditional mean based on historical excess returns data, but is considering the use of the dividend growth model (representing the conditional mean) and a mechanistic updating of the market risk premium whilst the RoRI is in force. We favour this alternative as we believe, along with the ENA, APGA and the experts in the AER's expert conclave, that the true market risk premium is informed by both the unconditional and conditional means. However, we agree with the ENA and APGA that the version of the dividend growth model the AER has suggested produces a conditional mean whose long term component is inconsistent with the unconditional mean the AER is using. For this reason, we submit that the version of the dividend growth model put forward by Frontier, which fixes this inconsistency, should be used.

In respect of beta, we note the ENA submission which points out that the AER views the energy assets it regulates as having amongst the lowest levels of systematic risk in the world, which does not seem credible. In our case, we have assets in Western Australia which the Economic Regulation Authority, operating under the same regulatory framework as the AER, considers has some 33 percent higher systematic risk than would be the case for an otherwise identical pipeline on the East Coast, where the energy sector is arguably facing more risk at present with gas supply constraints and other issues. We believe that the key difference does not lie in differences in systematic risk, but rather lies in the data used to calculate beta.

We consider that the ERA's approach in response to there being a single live Australian firm providing data makes use of data from other jurisdictions is the appropriate response. The AER has recognised that the lack of live data is problematic, but has not provided any guidance to stakeholders about how it might address this issue in future. We do not believe this is likely to support confidence in the regulatory system.

We hope that this feedback assists you in developing a final Rate of Return Instrument which. If you have any queries associated with this submission, please do not hesitate in contacting either Nick Wills-Johnson or myself.

Yours sincerely,

[redacted]

Roxanne Smith
Executive General Manager - Corporate and Regulation