



Australian Energy Regulator

By e-mail: RateofReturn@aer.gov.au

APA submission on Pathway to 2022 rate of return instrument and Rate of return Annual Update (December 2019)

APA Group (APA) appreciates the opportunity to comment the consultation paper, *Pathway to the 2022 rate of return instrument*, which was published by the Australian Energy Regulator (AER) in November 2019, and on the first *Rate of return Annual Update*, which was published in December.

Consultation paper

APA is encouraged by the AER's publication of the consultation paper. It marks an early initiation of the review of the 2018 Rate of Return Instrument. This early start should allow more considered debate on issues which are likely to arise during the review. In the review which preceded the 2018 Instrument, a number of issues were, in our view, not fully explored because of the need to work within a relatively short timeframe which was being driven by the policy changes which introduced the rate of return instrument into the national energy laws.

In setting out the pathway to the 2022 Rate of Return instrument, the consultation paper focuses on the process to be followed. In APA's view, process issues were largely settled with the amendments to the national energy laws and their implementation late in 2018. We would expect, going forward, a stronger emphasis on substance and outcomes, rather than on process issues.

Asset prices and rates of return are correlated with broader macro-economic conditions: Equity prices rise – and equity returns fall – during upswings; prices fall – and returns rise – during downturns. Interest rates typically rise during upswings, and fall during downturns. But what happens when, as now seems to be the case, the world economy is transitioning into a low growth, low inflation, low interest rate state? Yields on low risk government bonds may be at all-time "lows", but there is increasing uncertainty about future economic prospects.

The rate of return of the Rate of Return Instrument is a "forward looking" rate, and the risk premiums which must be taken into account when determining that rate are driven by expectations.

We may continue to use the economic models previously used in rate of return determination (although this should be confirmed). Those models are models of expected rates of return. But the ways in which expectations are incorporated into the models, and the ways in which expectations are measured, will have to be carefully assessed as part of any process to determine rates of return at which electricity network and gas pipeline service providers will invest for the long interest of consumers.

In rate of return determination for the 2022 Instrument, there cannot be the same reliance on historical information as was the case in 2013, or in 2018: judgement will have a greater role to play, particularly in relation to expectations.

In changing economic conditions, the review leading to the 2022 Rate of Return Instrument cannot be an incremental review like the review which preceded the 2018 Instrument. Rate of return determination will be a more difficult task with an increased role for judgement over purely technical analysis. The focus must now be on the substance of this task to ensure that the Rate of Return Instrument sets the right rate of return.

Consumer Reference Group

The Consumer Reference Group (CRG) is now an integral part of the rate of return determination process. Energy consumers should decide on how best the CRG might contribute to that process, including through its collaboration with the Consumer Challenge Panel.

Investor and Retailer Reference Groups

The AER's establishment, in 2018, of investor and retailer reference groups was, we think, an important innovation in bringing a broader range of views to the process of rate of return determination. Investors are the only group of stakeholders with direct experience of financing energy infrastructure.

Investors are well placed to advise on the judgements which must be made in determining a rate of return. We believe their advice to be as important as the advice the AER Board is proposing to seek from (primarily academic) experts through its concurrent evidence sessions.

We are aware that, in 2018, members of the Investor Reference Group attended discussions with AER staff, provided submissions, and contributed at a number of workshops and forums. Also, an investor-nominated expert attended the concurrent evidence sessions and addressed, from a practitioner perspective, questions from the AER Board. However, investor input seems largely to have been in respect of the technicalities of models and methods. It was not at a more strategic level.

Dialogue with senior representatives of the investor community is, we believe, essential to the AER Board understanding the rates of return required by investors.

Concurrent evidence sessions

APA attended, as an observer, one of the two concurrent evidence sessions which were held during development of the 2018 Rate of Return Instrument.

We found the experience very useful in exposing us to the full range of issues of concern to stakeholders, and in informing our understanding of the ways in which those issues were perceived and assessed by different experts.

Although the concurrent evidence sessions are not requirements of the national energy laws, we strongly support their continuation.

We do not propose any change in the purpose of the sessions: their purpose can remain the provision of expert opinion to the AER Board. Nor do we propose any change in "format": we do not think direct stakeholder participation in the sessions is necessary. However, we strongly support:

- convening at least one additional session – in our view, just two sessions will be inadequate to allow technically complex issues to be explored
- allowing a larger number of attendees – this may require a larger venue, but should not detract from the purpose of the sessions if attendees are restricted (as they were in 2018) to being observers (and not participants in the discussion)
- continued production of the Joint Expert Report as a summary of the proceedings of the evidence sessions – when making subsequent submissions, we found the Joint Expert Report more useful than the transcripts from the sessions themselves.

Independent Panel

The Independent Panel is now a part of the schemes of the National Electricity Law and the National Gas Law. The AER must seek a report on a draft rate of return instrument from the Panel, but the instrument remains the AER's instrument.

APA is aware that others have proposed that stakeholders have direct contact with the Independent Panel. This would, we believe, obscure the statutory accountability of the AER for determination of the rate of return. We do not support a more extensive role for the Panel.

Rate of return Annual Update

APA found the December 2019 *Rate of return Annual Update* a useful summary of information currently used for rate of return determination in accordance with the requirements of the 2018 Rate of Return Instrument.

We shall, as the AER suggests, defer any comments we may have on the way the information has been calculated, and on the implications for the 2022 Instrument, until the active phase of the 2022 review.

In 2018, the AER published two spreadsheets which assisted our understanding of the way in which key rate of return inputs had been calculated. These were:

- Risk free rate analysis.xlsm (20 July 2018)
- Historical excess returns and Wright approach data.xlsx (20 July 2018)

We would like to see these spreadsheets periodically updated and made available as appendices to subsequent issues of the *Rate of return Annual Update*.

APA would be pleased to elaborate on any of the views in this submission. Our work on rate of return is being undertaken by John Williams, who is in our Perth office and can be contacted directly on


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