25 November 2022

Dear Warwick ,

2022 Rate of Return Instrument Review - Release of Treasury Advice to AER

The Australian Pipelines and Gas Association (APGA) represents the owners, operators, designers, constructors and service providers of Australia's pipeline infrastructure, connecting natural and renewable gas production to demand centres in cities and other locations across Australia. Offering a wide range of services to gas users, retailers and producers, APGA members ensure the safe and reliable delivery of 28 per cent of the end-use energy consumed in Australia and are at the forefront of Australia's renewable gas industry, helping achieve net-zero as quickly and affordably as possible.

APGA welcomes the Release of Treasury Advice to Australian Energy Regulator (AER) following the review of the Rate of Return Instrument (RoRI) and the opportunity to comment on the options the AER has proposed.

The AER has not identified the intent behind proposing new options in response to the Treasury Advice. APGA would have preferred more detail about the intent underpinning any changes beyond the Draft 2022 RoRI. This would allow for the consideration of proposed changes relative to the AER's intent.

Without a clearly stated intent, APGA infers from the proposed options that the AER intended to achieve either of the following outcomes through the proposed options:

a) Seek a better estimate of the unconditional mean; or
b) Seek to update the MRP.

Considering these inferred intentions, APGA notes that:

- If the AER is seeking a better estimate of the unconditional mean, and considering the AER's view of the relevant data, a better solution would be to use more of the historical data it currently does not use rather than adding 2022 to its sample set; and
- If the AER is seeking to update the MRP then the more appropriate response would be to use a mix of unconditional and conditional mean information as proposed in APGA's response to the AER's Option 3b from its Draft RoRI.

APGA welcomes the opportunity for further engagement with the AER if it has not correctly inferred the intent behind the options from its Treasury Advice.

Further detail on how to more effectively achieve each preferred option, alongside detail of untenable options, can be found below.

Detailed recommendation background

As noted above, APGA believes there are two potential preferred options noting that neither option directly correlate to the AER's 2 November paper.

If the AER is simply looking for more data to get a better estimate of the unconditional MRP it would be more appropriate for the AER to make use of the decades of historical data available to it but which it has not used rather than adding a single new year of data. Dr Lally's advice to the AER is that the MRP is mean stationary and thus it has no trend.[1] This in turn means that 2022 is no more valuable than any other year in respect of informing the MRP. Indeed, if the MRP cycles it may be less valuable than more data on past cycles.

If the AER is seeking to capture the most recent data, then it is in effect suggesting that the conditional mean should be given more weight. If this is the case, then the AER should make use of a model which appropriately incorporates the conditional mean rather than adopting an ad-hoc solution like adding one more year of data. This would represent a form of Option 3b from the Draft RoRI which APGA has provided its views on how to implement.[2]

The AER has expressed misgivings about the DGM in the past. APGA suggests an assumption that one year of recent data is able to better reflect current investor expectations than a DGM is a bold, untested assumption that risks far greater issues than any flaws in the DGM might create.

We note also that a view that the MRP should reflect the latest information leads logically to periodically updating the estimate of MRP during the period of the 2022 RoRI. This is because there is nothing special about December 2022 in providing an MRP that reflects the expected future market conditions. In the context of the AER's November 2 options, it would be not be logical to choose the 4th option (stopping at the December 2022 data) without updating through the course of the RoRI period.

Untenable options

The second and third options suggested by the AER in its November 2 paper (the use of data only to December 2019 and using 2022 data to September) are untenable solutions regardless of intent.

Considering the second option proposed by the AER, APGA's perspective on removing data communicated in its response to the Draft 2022 RoRI has not changed. Rather, APGA's view has been strengthened by evidence from Energy Networks Australia (ENA) that the years in question are not, in fact, abnormal.[3]

---

[1] *See the Explanatory Statement of the AER's Draft RoRI, p131, available [here]*
[2] *See the APGA response to the AER's Draft RoRI, p14, available [here]*
[3] *See pages 16 to 19 of the ENA's submission to the AER's November 2 paper.*

Further, as APGA notes in its submission to the Draft RoRI any approach which seeks to remove data on the basis of abnormality would need to look at all aspects of the AER's Weighted Average Cost of Capital (WACC) model. Choosing to remove data from one variable introduces the risk that remaining variables carry the identified abnormality into the equation. This would undermine the AER's intent in removing data in the first place.

If a principle is adopted that data may be removed on the basis of potential abnormality, then this judgement call risks opening a large and unproductive process of debate amongst stakeholders who will each have different views on what is abnormal. This is especially the case where there is no clear and consistent expert view on the topic. In the context of the MRP for example, experts noted no consistent view on how to estimate the conditional mean let alone what data might be relevant.

The decision to remove data may also mean that the AER needs to reconsider its approach to estimating the MRP. The AER states that an MRP which is fixed through the RoRI is appropriate and that the risk free rate picks up market movements.[4] However, removing some years of MRP estimates due to concerns about monetary policy and its influence on the MRP as per the Treasury note suggests that the risk-free rate proxy in those years is affected by government policy and may not reflect market movements. This suggests in turn that it is not appropriate to assume that the MRP is constant, but rather that the AER should incorporate the conditional mean into its estimation of MRP

In respect to the AER's third option, APGA is concerned about the potential impact on investor expectations. Whilst we accept that the AER is responding to advice from the Independent Panel it will not escape investors' notice that any option which includes data from the year of the RoRI would have increased the MRP in 2013 or 2018 but will likely decrease it in 2022.[5] September 2022 appears to be a low point for returns in 2022 to date. Choosing September 2022 as the proxy for 2022, particularly now that December 2022 is feasible given the AER's decision to delay its final RoRI to February 2023, is likely to cause investors' concern in respect of the AER's objectivity.

Summary of views

APGA considers the following views are consistent with its inference of the AER's intent:

- If the AER is seeking a better estimate of the unconditional mean, it should use the decades of historical data which are available to it, rather than a single recent data-point. This would be consistent with technical advice it has received on the nature of the MRP, and with the views of experts in the conclaves who advocated a much longer time series; and
- If the AER is seeking to reflect recent information then it should use a proper model of the conditional mean, as detailed within APGA's submission on how to implement Option 3b from the Draft RoRI. At a minimum, updating the measure of the MRP through the period of the RoRI is the only approach which is consistent with the view that recent information has special weight.

[4] *See the Explanatory Statement of the AER's Draft RoRi, p162, available here.*

[5] *See pages 28 to 30 of the ENA submission to the November 2 paper*

APGA considers the following is inconsistent with its inference of the AER's intent:

- Selectively removing data from a historical series, which introduces bias. This is especially the case if only some data points in some parameters are considered. Moreover, introducing a practice whereby judgement calls are made on data removal is risks needless and extensive debate as views on what should be removed will differ widely
- Updating data to only September 2022, which may appear to investors as selectively picking a low point in the year to lower returns to them and is likely to be seen by investors as untenable under the remit of the NGO.

We hope this submission assists you in responding to the recommendations of the Independent Panel and the advice from Treasury. We would be happy to discuss any matters raised in this submission with you at your convenience.

To discuss any of the above feedback further, please contact APGA's National Policy Manager, Jordan McCollum, on [redacted] or [redacted]

Yours sincerely,

[redacted]

STEVE DAVIES
Chief Executive Officer
Australian Pipelines and Gas Association