AusNet

2 September 2022

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Mr Warwick Anderson
General Manager
Australian Energy Regulator
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Dear Warwick

Response to the Draft 2022 Rate of Return Instrument

AusNet welcomes the opportunity to respond to the Draft 2022 Rate of Return Instrument (RORI). This is a critically important review which will determine whether regulated returns are sufficient to ensure efficient investment is undertaken in the critical period of the energy transition. The AER must strike an appropriate balance – if allowed returns are too low, too little network investment may occur which will slow the transition to renewables and customers will forego energy bill savings due to lower wholesale market prices. If allowed returns are too high, inefficient investment may be encouraged, which would unnecessarily increase customer prices.

In addition, the 2022 RORI will impact investment incentives and prices from 2023 until 2031, and future economic conditions are uncertain. The 2018 RORI was challenged by the historically low interest rate environment during its tenure, leading to Australian equity returns falling below those of any comparable jurisdiction. The AER must be mindful of the range of economic scenarios that could occur over the tenure of the 2022 RORI and ensure it is based on strong evidence of required returns and is robust to a range of scenarios.

Reflections on the Draft 2022 Rate of Return Instrument 'In the Round'

We do not consider the Draft 2022 RORI will achieve the AER's own guiding principle of providing:

> *an unbiased estimate of the expected efficient return, consistent with the relevant risk involved in providing regulated network services*

Following a 2½ year consultation process, the Draft 2022 RORI proposes to make one major change to the 2018 RORI approach to setting returns; that is, to reduce the term of equity from 10 to 5 years. Other elements of the 2018 RORI have been retained.

The move to a 5 year term on equity introduces a material distortion, or a bias, between the AER's allowed cost of equity and the efficient return. The reasons for this are detailed in Energy Network Australia's submission, which we fully support.

During the consultation process, significant concerns were raised by stakeholders and consultants engaged by the AER on the robustness of its approach to different economic scenarios, and Australian equity returns being below those handed out in comparable jurisdictions, including after adjustments to account for jurisdictional differences. Neither of these central concerns have been address by the Draft 2022 RORI.

Indeed, the Draft 2022 RORI appears to be less robust to economic changes than the 2018 RORI. Since the 2018 RORI was made, the Australian economy has experienced historically low, supressed, returns and inflation, followed more recently by a high inflationary environment with rapidly increasing interest rates. Temporary factors (including the war in the Ukraine creating supply chain challenges) have contributed to this at least in part. It is uncertain whether the current conditions will continue, stabilise at levels of interest rates and inflation in line with long-run averages or reverse, leading to a return to supressed market conditions.

In this uncertain environment, the 2022 Draft RORI will deliver volatile returns as it continues to embed a 1:1 relationship between the risk free rate and government bond yields. The impact of this on the 2018 RORI was that equity returns plummeted below the equity returns handed out by any comparable international regulator, as confirmed by a Brattle report commissioned by the AER early in the process. If this outcome is repeated during

the period to which the 2022 RORI will be applied there is a risk to delivery of a lower cost reliable energy transition, given the very significant amounts of capital needed to deliver the efficient network investment.

By moving to a 5 year term of equity the AER has heightened this risk as, on average, returns are expected to be lower than delivered under the 2018 RORI. In addition, the AER has introduced new risks with this approach – during economic crises, the 5 year government bond rate has been observed to materially exceed the 10 year bond rate. That is, if the AER switch to a 5 year equity term, customers could face higher bills during crisis periods than if the 10 year term were retained.

This was last the case in Australia during the Global Financial Crisis, but notably in the US the 5 year government bond rate is **currently** above the 10 year government bond rate (that is, the yield curve is inverted), which means that the 2022 RORI could increase prices relative to the 2018 RORI during the current cost of living crisis.

In summary, we consider that the AER has missed an important opportunity to fix material shortfalls of its approach, specifically its robustness to economic conditions – despite a long consultation process where many constructive ideas from stakeholders, including ENA, were forthcoming. In particular, the AER has shortened the term of equity – which leaves the 2022 RORI less robust than the 2018 RORI – an idea that has not been strongly and consistently advocated by any stakeholder to the review and is not supported by any sound evidence or reasoning (see below).

The Current Cost of Living Pressures

We acknowledge the concerns raised by customer groups engaging in this process – including the Australian Council of Social Services (ACOSS) and Energy Consumers Australia (ECA) – about the current cost of living crisis and the impacts this is having on many customers. We are committed to engaging in industry processes including the current process run by the AER to support customers experiencing vulnerable circumstances. We have also:

- Co-designed a Priority Service Program with customer welfare agencies as part of our gas regulatory proposal; and

- Sought applications for a $30k grant for research targeted at improving understanding of how distributors can assist customers experiencing vulnerability.

In relation to the rate of return, we support the AER's guiding principle that it should target:

> *an unbiased estimate of the expected efficient return, consistent with the relevant risks involved in providing regulated network services. We consider that the NEO, NGO and the long term interests of consumers are best served through this guiding principle*[1].

The Consumer Reference Group (CRG) has advocated that the AER should 'look through' shorter-term impacts to the long-term interests of consumers: '*the AER's task is to 'look through' the shorter-term business cycles and various economic disruptions. Instead, the AER's task is to recognise and respond to the longer-term expectations and behaviours of investors and consumers*'[2]. The ENA has advocated that the AER should design a RORI which is robust to a range of economic conditions, given it will apply to revenues until 2031 and there is significant uncertainty over economic conditions that may result.

It is also important to consider that as the energy transition accelerates, network investment is increasingly required to deliver market benefits; lowering wholesale prices due to the efficient incorporation of renewables. We understand that customers are more concerned about their total energy bill than the network component specifically, and market bodies acknowledge that there may be a need for increasing network investment to unlock the wholesale market price benefits of renewable generation. For example, AEMO has confirmed the ISP's Optimal Development Path is projected to lower overall customer bills by $2.20 for every $1 spent. Distribution networks are also investing to provide export services to customers with behind-the-meter DER investments, again

[1] AER, *Rate of Return and Assessing the Long Term Interests of Consumers*, Position Paper, 20 May 2021
[2] CRG, *Response to the AER's July 2021 draft working papers – Volume 1*, 3 September 2021, p. 31

suppressing wholesale market prices. In this way, increasing network investment can serve to lower the overall bill for consumers.

Importantly, under the regulatory framework, this investment cannot proceed unchecked. Checks and balances are built into the framework to ensure that investment is only undertaken where the benefits to customers outweigh the costs, i.e. that it is efficient. These include the AER's approval of efficient ex ante expenditure allowances, the ex-post review process, the requirement to run Regulatory Investment Tests and Contingent Project Applications for large ISP projects. These features of the framework should provide comfort to consumers that the networks cannot invest unbridled, regardless of the rate of return that is set. However, to unlock the customer benefits described above it is essential that the rate of return set by the AER ensures that investors are adequately compensated for investing.

Return on Equity

The AER should make the following amendments to its approach to equity:

- Retain a 10 year term. The overwhelming weight of evidence supports a 10 year term, which raises concerns about regulatory predictability and stability for investors in Australia, particularly as IPART, the QCA and the WA ERA have each moved from a 5 to a 10 year term for equity in recent years. It is unclear why the AER is doggedly pursuing such a change when it has not been consistently advocated for by any stakeholder in this review, is a significant departure from mainstream regulatory practice here and overseas and could lead to higher prices for customers if the yield curve inverts (as it has in the US) in the current crisis.

- Only rely on the Dividend Growth Model (DGM) to estimate the Market Risk Premium (MRP) if ENA's calibrated DGM is used. The AER has repeatedly raised concerns about the stability of DGMs and the assumptions required to parameterise the model. ENA's calibrated DGM ensures the average estimate of the MRP matches the Historical Excess Returns (HER) estimate applied by the AER, and therefore eliminates any bias. The AER proposes to use the 3-stage model (despite disregarding this same model in the 2018 RORI), however, this gives average results materially below the HER estimates. Applying this model introduces inconsistency between the two estimation techniques and a downward bias in the MRP.

Further detail on these positions, and on equity beta, are outlined in ENA's submission.

Return on Debt

We support the AER's decision to continue with the benchmark approach to setting the cost of debt. While we support the AER collecting data to constitute the Energy Infrastructure Credit Spread Index (EICSI), we agree with the AER that it can be most effectively used as a cross-check on the validity of the benchmark approach, rather than being deterministically applied to set the debt allowance. Indeed, the EICSI confirms that outperformance is very low compared to the debt allowance.

The consultation process for debt has been thorough but commenced with the AER producing analysis comparing actual debt costs with the industry benchmark on a different basis to that done in the 2018 RORI process. This analysis purported to show that there was significant industry outperformance (100bp +) of debt allowances. The AER's updated analysis correctly compares actual debt data with the benchmark on a like-for-like basis, in the same way that was done in the 2018 RORI, and concludes outperformance is minimal (around 4 basis points). To improve the efficiency of the process for the 2026 RORI, we suggest the AER repeats its analysis in its annual updates to ensure stakeholders have a mutually understanding of its conclusions and any trends in the results over time.

Regarding the AER's proposal to move forward the timing of the allowed debt averaging periods by a month, we do not support this change. This will increase costs for some networks, as debt raising that is anticipated to occur 5 months prior to the commencement of a regulatory year will now no longer be eligible to set debt revenues for the next regulatory year. For businesses that seek to hedge their debt portfolio, forward-starting hedges for debt raised in this month would need to be extended by a year.

AusNet

CEPA Report on RAB Multiples

The AER has invited comments on the CEPA report[3] it has commissioned on RAB multiples arising from the AusNet and Spark transactions as part of the Rate of Return process. As one of the businesses examined by this report, we were disappointed not to be consulted by CEPA on its work and conclusions, which would have likely improved the accuracy and validity of its conclusions. CEPA made some fundamental errors in its analysis, most strikingly the valuation of AusNet's Development and Future Networks business, which has a current Contracted Asset Base value of $0.9bn, more than double CEPA's 'high end' valuation. This error has arisen from CEPA using an inappropriate valuation methodology which does not reflect the nature of the business and ignoring key evidence in the Independent Expert Report prepared for the AusNet acquisition.

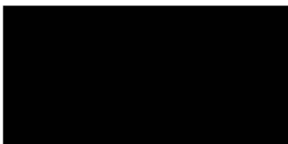
We set out these concerns in our letter[4] to the AER on 31 May 2022 and we also support the concerns raised by the ENA[5].

We reiterate our strong view that the CEPA Report should not have a role in this process for the following reasons:

- The analysis contains serious flaws and cannot be relied upon; and
- It would be very poor process if the AER relied on the report in any way in its Final RORI, given the AER's own interpretation of this report including its views on its relevance to the RORI has not been presented for consultation or considered by the Independent Panel.

We fully support ENA's submission, including the comments on the Independent Panel's report. We look forward to continuing to engage in this review. Please contact me on with any questions about this submission.

Sincerely,



Charlotte Eddy
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AusNet Services

[3] CEPA, *EV/RAB Multiples*, 10 May 2022. Accessed here: EV/RAB multiples (aer.gov.au)
[4] AusNet, Letter to Clare Savage re CEPA RAB Multiples report, 31 May 2022, accessed here: Ausnet - CEPA Regulatory Asset Base (RAB) Multiples - Report for the AER - 31 May 2022.pdf
[5] ENA, letter to Clare Savage re CEPA Report EV/RAB, 27 May 2022, accessed here: ENA - 2022 Rate of Return Instrument Review - CEPA Report EV_RAB Multiples - 27 May 2022.pdf (aer.gov.au)