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Via email: RateofReturn@aer.gov.au

Dear Warwick

Re: Response to Rate of Return Information Paper

We are pleased to respond to this consultation on the 2022 RORI. This is a critical part of the 2022 RORI consultation process, as the AER has now finalised all the working papers and the Expert Sessions have recently concluded. The next major milestone is the publication of the Draft RORI in June 2022.

We strongly support the ENA's submission. Our short submission offers some additional comments.

Importance of network investment

We are facing a need for increased network investment over the next couple of decades. This is required to:

- Support the integration of renewables into the grid to facilitate the energy transition.
- Support the decarbonisation of the gas and the transport sectors.
- Increase the resilience of the network in the face of climate change.

The need for additional network investment is well-understood and accepted by stakeholders, with the Chair of the AEMC noting that:

Beyond what we pay for the generation of electricity, between one-third and half of every electricity bill goes to pay for the towers, poles and wires that deliver that electricity to where it is needed. These prices are going up and are expected to accelerate over the years ahead as significant new investments are needed to connect new renewables.¹

Importantly, consumers will see savings because of this increased investment. Efficiently integrating renewables into the system will lead to lower wholesale market prices, and electrification of gas and transport will lead to lower or zero gas and petrol costs for consumers.

In this context the task for the AER in setting an appropriate rate of return to attract efficient network investment becomes particularly important. The benefits of network investment are far broader than they have been in previous RORI reviews – where price/ reliability trade-offs were the key focus.

¹ Road to Cheaper Energy, Anna Collyer, *The Australian*, 29 November 2022

Now network investment can also deliver wholesale market price reductions, facilitate decarbonisation and improve resilience benefits. Setting a rate of return that is inefficiently low in this context will deny consumers a broader range of benefits than was the case in the past.

Our expectations

We expect the AER to set an unbiased estimate of the expected efficient return, consistent with the relevant risks involved in providing regulated network services.

We also consider it critical that the AER addresses the following matters, to ensure that efficient investment in energy networks is promoted during the critical transitional period to which the 2022 RORI will apply:

- The Brattle report commissioned by the AER demonstrated that the AER's allowed return on equity was lower than that of all comparable regulators that were examined.
- The AER's return on equity has been at historical lows under the 2018 RORI period. The exceptionally low returns applied under the 2018 RORI do not just reflect the historic low risk-free rate, but also the AER's approach to setting the cost of equity, which Brattle concluded was not as effective as other regulators.
- Equity returns this low are not supported by evidence. The independent expert valuation reports prepared as part of the recent Spark Infrastructure and AusNet Services transactions concluded that the current market cost of equity capital (with gearing at 60%) is materially higher than the AER's current allowance.

ENA's submission discusses these concerns in more detail – we support their views.

Gas network risk

Recent developments in the Victorian Government's Gas Substitution Roadmap consultation process have highlighted the increased asset stranding risk involved in providing regulated gas network services. Specifically, an extremely aggressive electrification pathway has been modelled which, if adopted in policy, will have a materially adverse impact on our ability to recover the full value of our sunk assets through regulated charges.

Notwithstanding this risk, we continue to support the regulatory framework's strong asset stranding protections and the provision of a rate of return which reflects the very low levels of stranding risk ordinarily faced by regulated networks. Asset stranding protections should be maintained by the regulatory framework or by government (where the framework is not best placed to absorb the full extent of increased stranding risks) to ensure customers to continue to benefit from a relatively low rate of return.

Debt

We support the AER's move away from using industry debt data (the Energy Infrastructure Credit Spread Index (EISCI)) to deterministically set any part of the debt allowance.

While we agree that outperformance that is material and persistent should be removed from the debt allowance, the AER's analysis confirms there is no evidence of material outperformance. This result should be welcome to consumers as it confirms the AER's current debt benchmark approach is working well and has not required customers to pay more than efficient debt costs.

On a credit rating and term-matched basis, the AER finds that residual outperformance is around 4 basis points, with a standard error of 15 basis points. This highlights the variability of the industry debt dataset and confirms it cannot be concluded that there has been any statistically significant residual outperformance. While the AER will receive another year of debt data prior to the final RORI, industry data during this year will likely be impacted by the AusNet transaction and potentially the Ukrainian crisis. The period being considered by the AER in the 2022 RORI has featured many unprecedented circumstances and applying this data deterministically to set a forward-looking benchmark could be particularly unsafe, providing further support for the AER's current benchmark approach.

We cannot see a basis to adjust the benchmark term from 10 years, given current industry data shows an average 10.2 year term at issuance (excluding NSW firms that have been recently privatised). The AER also confirms that outperformance due to differences in credit ratings is minimal.

We continue to support the inclusion of subordinated debt in the EISCI. The AER's Omnibus paper references Lally's recognition that whether subordinated debt should be included or excluded depends on the use of the EICSI. However, the AER misquotes Lally – Lally agrees with ENA that if the EISCI is being used directly to set the Debt Risk Premium (DRP), subordinated debt should be included in the EISCI:

The ENA (2020b, para 28) argues that the average DRP in the EICSI data should include subordinated debt because it includes the senior debt that the excluded subordinated debt supports. If the EICSI data were being used to directly set the allowed DRP for the regulated businesses, I would agree, otherwise use of the average DRP in the EICSI data to generate the allowed DRP for regulated businesses would fail to match the costs of these businesses in aggregate².

However, in the final Omnibus Paper the AER states:

We note though that consistent with the advice from Dr Lally, whether subordinated debt is included/excluded depends on the use of the EICSI. If the EICSI is to be used to directly set the debt premium, then it is beneficial to exclude it from the analysis to ensure it matches the costs of these businesses in aggregate.³

If the AER is adopting Lally's advice on this point and it does apply the EISCI to set the DRP (either directly or through an adjustment to the credit rating) it is critical that subordinated debt is **included** in this index. In the Draft RORI both the role of the EISCI and, consequently, the treatment of subordinated debt in the EISCI should be clarified by the AER.

Regarding the application of a capex weighted trailing average cost of debt, we have previously indicated that there may be merit in this proposal. However, there are some complex implementation issues that will need to be considered in detail, both if applied to large transmission investments and if applied to all networks. The Information Paper does not outline the full mechanics of the approaches suggested by the AER. If the AER wishes to continue to progress this, a detailed consultation on the specifics of the approach is required.

Use of RAB multiples as a cross check

We support the AER's position that RAB multiples can provide contextual information, but they cannot be used to reliably determine the degree of outperformance on the rate of return. This is because it is

² Dr Martin Lally, The Appropriate Term for the Allowed Cost of Capital, report for AER 9 April 2021

³ AER, Overall rate of return, equity and debt omnibus, Final Working Paper November 2021, p75

impossible to disaggregate and understand the various drivers of RAB multiples based on publicly available information. Drivers of the multiples could include:

- Tax depreciation benefits. These benefits can be material – Grant Samuel’s Independent Expert Report (IER) in relation to AusNet’s recent change of ownership contains scenario analysis for each of AusNet’s four networks, demonstrating the magnitude of the impact this can have on company valuation. Importantly, and as the AER concluded in its 2018 Tax Review, customers of regulated networks neither fund the expenses of transactions nor do they receive the additional tax benefit – they fund benchmark tax costs (which since 2018 are closely aligned with Australian Tax Law in respect of regulated network activities).⁴
- Economic conditions, impacting the demand for regulated entities. Over the last couple of years demand has been particularly high.
- Potential for expenditure reductions, for example due to expected synergies with the acquirer’s business operations or savings from becoming delisted.
- Potential for unregulated growth, which is becoming an increasingly important driver due to the need for material transmission investment across the NEM.
- Network-specific factors. Grant Samuel’s IER for the AusNet transaction valued each of our three regulated networks and our growth business separately. The RAB multiples assigned to our regulated networks ranged from around 1.2x RAB (electricity transmission and gas) to around 1.6x RAB (electricity distribution). This illustrates there are a range of network-specific drivers involved in regulated network valuations, not only the adequacy (or otherwise) of returns.

There is little evidence that outperformance in the rate of return is a material driver of recent multiples. Indeed, the IERs for the AusNet and Spark transactions apply a cost of equity in their discount rate which is materially above the 2018 RORI cost of equity, demonstrating a likely negative impact on RAB multiples associated with regulated equity returns. This is explained in more detail in the ENA’s submission.

The AER must consider the evidence provided by IERs as the best publicly available source of information as to the drivers of company valuations during transactions. The regulations governing the preparation of these reports should give the AER confidence in their robustness. While in the past the AER has expressed concerns that the role of the independent experts does not align with the AER’s regulatory task, this concern can equally be applied to the role of acquirers purchasing regulated entities and driving the RAB multiples the AER is giving weight to. The AER should look at both RAB multiples and IER alongside each other, and not disregard one of these sources of evidence as being more or less relevant than the other.

Please contact me [REDACTED] with any questions in relation to this submission.

[REDACTED]

Charlotte Eddy
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⁴ AER Final Report – Review of Regulatory Tax Approach – December 2018, p10