



Ausgrid Submission

Rate of return and cashflows in a low interest rate environment
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Dear ██████████

Ausgrid welcomes the opportunity to provide this submission to the AER's working paper on rate of return and cashflows in a low interest rate environment. The rate of return instrument is one of the most significant decisions made by the AER in terms of its effect on both outcomes for customers and the financial stability of network businesses.

As highlighted in other industry and investor submissions, returns have been severely constrained since the 2018 rate of return instrument. It is critical that the rate of return is set a level that is robust to all economic circumstances and allows networks to support the energy market's transformation, promote efficient investment and provide customers with desired outcomes.

Our submission outlines why the low rate environment has had an impact on network businesses, and that financeability testing is good regulatory practice to validate internal consistency of assumptions used to calculate the revenue of a benchmark efficient entity.

We look forward to engaging with the AER and other stakeholders throughout the rate of return review process. If you would like to discuss our submission in more detail, please contact ██████████
██████████ on ██████████ or ██████████.

Yours sincerely

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Chief Customer Officer

Introduction

The rate of return instrument is one of the most significant decisions made by the AER in terms of its effect on both outcomes for customers and the financial stability of network businesses. The consequences of setting rate of return too high or too low can have significant effects on both.

The Rate of Return Instrument 2022 (RORI) is occurring when we are at a critical juncture in the transformation of the energy sector, with changes in the NEM over the next 5 to 10 years likely to have long term impacts for customers. For example, over the coming years there is an emerging need to invest in the capabilities required to efficiently integrate distributed energy resources (DER). Investing in reliability, resilience and the capability to flexibly respond to extreme weather risks is also an emerging need for networks, as global mean temperatures continue to rise.

In this context, the industry is facing its lowest ever returns, and is receiving the lowest equity returns in comparison to relevant international peers. The ability to attract investment is increasingly difficult, and the possible changes being investigated by the AER and raised in the Rate of return and cashflows in a low interest rate environment working paper (working paper) would further decrease returns. The continuous erosion of returns over time is likely to compromise networks' ability to provide the customer benefits and choice that are needed to support the transformation of the energy sector.

Are we in a low interest rate environment? What are the consequences of low rates?

The working paper concludes that we are experiencing a low rate environment based on historical data. Ausgrid agrees with this conclusion.

The consequences of low rates pertain to the equity component of rate of return. Debt in a low rate environment is of less concern because interest rates are observable and are updated annually throughout a regulatory period, so significant market movements within a regulatory period are accounted for. Debt is also a direct cash cost, where both the cost and allowance increase and decrease with the market.

Equity is the component which is of greatest concern in the low rate environment. Return on equity under the 2018 RORI is extremely low, both in absolute terms and in comparison to other regulated utilities. Brattle's report to the AER in 2020 highlighted that equity returns were the lowest among international comparators¹ and since then have reduced further due to the lower risk free rate. While full exposure to spot risk free rates is a matter of concern in the regulatory framework (see next section), the reduction that was made to equity risk premium (ERP) due to underlying methodological changes in the 2018 RORI also is of great significance.

The context of historical low rates is important to gain an understanding of the compounding impact of a low ERP and continuing reductions to the risk free rate. The AER's analysis of the impact of low rates, provided by the ACCC Regulatory Economics Unit (REU), is driven by economic theory whereas we believe that financial realities are at least equally, if not more, important. Negative NPAT is not considered to be an issue in the working paper because over the life of an asset the expected NPAT is positive due to some of the return being delivered through future capital gains². Unfortunately, future capital gains are not included in debt and credit metrics which are impacted by the factors that affect NPAT. Comparisons to specific companies or other sectors which have been raised in this working paper³ and the inflation review⁴ do not take account of how financing works for network businesses.

¹ Brattle Group, A Review of International Approaches to Regulated Rates of Return, June 2020, p 50.

² AER, Rate of return and cashflows in a low interest rate environment | Draft working paper, May 2021, p 42.

³ AER, Rate of return and cashflows in a low interest rate environment | Draft working paper, May 2021, p 42.

⁴ AER, Draft position | Regulatory treatment of inflation, October 2020, p 88.

At a time of unprecedented change in the energy industry strong financial statements and credit metrics are required to invest in networks of the future. Regulatory decisions that lead to the benchmark regulated firm producing losses, and compromising important credit metrics, are not conducive to attracting the funding required to maintain reliability, meet customer expectations of resilience and facilitate transformation of the network.

Have equity holder expectations decreased to the same extent as government bonds?

Relationship between risk free rate and return on equity

This question is effectively asking whether there is a one-to-one relationship between the risk free rate and expected return on equity, which is the underlying premise of return on equity in the 2018 RORI.

The critical point in the risk free rate/overall return on equity relationship is the methodology used to estimate market risk premium (MRP). In the 2018 RORI MRP was estimated using historical excess returns (HER), giving no weight to any other information. This effectively gives rise to a constant MRP because adding one year of data to a long data set has an immaterial impact on the average. As this estimate of MRP is stable over time it is sometimes above the actual MRP and sometimes below the actual MRP. By definition, a constant MRP has no relationship to the risk free rate because it will effectively remain the same regardless of the risk free rate.

On this basis, if the AER concludes that there is a relationship between risk free rate and MRP it would be inconsistent to maintain the HER only approach to estimating the MRP. The appropriate outcome would be to give weight to more forward-looking evidence in the estimate, because it would cause the MRP to move lower or higher in accordance with actual market conditions, inverse to movement in the risk free rate.

RBA interventions

An additional concern we have about the extent of recent reductions to the risk free rate is the RBA intervention in the market to manage the government bond yield curves. The RBA estimates that the extraordinary bond buying program has artificially reduced the risk free rate by around 30 basis points⁵. While the AER noted there has been a price impact, its view is that this does not change its characteristics as a proxy for the risk free rate⁶.

We consider that the impact of RBA intervention should be considered by the AER. Equity holder expectations have not decreased to the same extent as government bonds, and this has been exacerbated by government bond rates being lower than the level an efficient market would otherwise have reached.

We note that the components identified by the AER for further investigation in this and the term of the rate of return working paper are biased to the downside. That is, they would further reduce the rate of return from the current low level:

- Term of equity to five years;
- Term of debt to less than ten years; and
- Relationship between MRP and equity returns at a time when risk free rate is at its lowest point and expected to increase.

⁵ DeBelle, G, Monetary Policy During Covid, Shann Memorial Lecture, Reserve Bank of Australia, 6 May 2021, p 14.

⁶ AER, Rate of return and cashflows in a low interest rate environment | Draft working paper, May 2021, p 6.

At the same time, the AER has (on a preliminary basis) concluded that it does not need to take account of the financeability of network businesses, and whether the regulatory decisions are internally consistent. This is discussed further in the financeability section below.

Should the AER consider financeability in its decision making?

The AER has indicated that financeability tests are not required for regulatory determinations and is not convinced they are required for the RORI process⁷. There is a view that financeability is an issue for the businesses to manage through its own capital structure decisions⁸.

We are concerned that the AER and other stakeholders have misunderstood the industry's views in relation financeability testing. We do not propose that financeability be used to back-solve a rate of return or be used to set any parameters (i.e. be used deterministically). Our proposal is that it would serve as a cross-check for internal consistency of the RORI, which was recognised as its purpose by the REU:

If the test is applied to a benchmark entity its results can be interpreted as a cross-check for overall consistency of the benchmark parameters.⁹

We agree that businesses can choose to operate with parameters that vary from the benchmark allowances, and that sometimes actual businesses, as opposed to the benchmark efficient entity (BEE), may choose to vary their capital management to manage credit ratings/financeability. However, we disagree with the AER's conclusion that businesses do not have to be able to achieve the benchmark RORI assumptions at all times¹⁰. Our key concerns with this are:

- The cash flows and capital structure of the benchmark efficient entity should be possible to achieve in theory and in practice, should a business choose to manage itself according to those settings. If it cannot, it must draw on other resources that are not compensated for within the regulatory framework; and
- It is unclear for how long a business should be expected to maintain a sub-optimal capital structure to manage its credit rating.

It seems reasonable and logical that the financial outcomes produced in the post-tax revenue model (PTRM) for a BEE should be consistent with input assumptions. If a certain credit rating is assumed, but the PTRM produces credit metrics that do not support that credit rating, a financeability test would provide early warning that the input assumptions require review. This is particularly important when setting the RORI because choosing each parameter is inherently imprecise and requires judgement.

It is also suggested that industry is only concerned with NPAT and FFO/Debt¹¹. These metrics have been of most concern to network businesses over the last few years, and FFO/Debt has been raised as a particular issue because rating agencies identify it as the most important of the quantitative measures. However, a proper application of financeability testing would include all metrics used by rating agencies when conducting their assessments. We recommend that any financeability test include the full suite of metrics to be applied with the appropriate calculation methods. If the outcome shows that the credit rating is not supported, it would be for the AER to decide the most appropriate action consistent with the national electricity objective.

Regarding NPAT, in its working paper the AER makes the following observation:

⁷ AER, Rate of return and cashflows in a low interest rate environment | Draft working paper, May 2021, p 48.

⁸ AER, Rate of return and cashflows in a low interest rate environment | Draft working paper, May 2021, p 47.

⁹ AER, Rate of return and cashflows in a low interest rate environment | Draft working paper, May 2021, Appendix B, p 62.

¹⁰ AER, Rate of return and cashflows in a low interest rate environment | Draft working paper, May 2021, p 47.

¹¹ AER, Rate of return and cashflows in a low interest rate environment | Draft working paper, May 2021, p 39.

A key driver of reductions in NPAT in recent AER regulatory decisions is the 2017-18 tax review and the consequential recognition of capital expenditure that is immediately deducted for tax purposes. Recognising immediate expensing of capital for tax purposes reduces NPAT, at least when capital intensive firms have ongoing investment programs.¹²

We are concerned that the AER has misrepresented how immediate expensing of capex has impacted NPAT. For the BEE in the PTRM, immediate expensing reduces the tax component of building block revenue, which reduces revenue. However, tax payable is also reduced so in the NPAT calculation there is also a lower tax payable. Therefore immediate expensing of capex has the effect of increasing accounting NPAT because the revenue is reduced by an amount adjusted for imputation credits, but the tax payable in the NPAT calculation is not. Depreciation is not affected because accounting depreciating, not tax depreciation, is used in the NPAT calculation. This does not materially affect the AER's conclusions, however it is important that stakeholders are provided correct information.

Implementation

The credit metric calculations, which are based on published material from at least one rating agency, could be built into the PTRM. The AER would assess all metrics and determine whether the quantitative score aligns with the levels generally used for the credit rating of the BEE. We recognise that rating agencies use judgement and wider knowledge of the longer-term outlook for and management of companies when giving ratings. However, it is possible for the AER to make a reasonable assessment as evidenced by implementation of financeability testing by other regulators, including Ofgem and IPART.

¹² AER, Rate of return and cashflows in a low interest rate environment | Draft working paper, May 2021, p 44.

A scenic landscape at sunset. A paved road with a dashed white line on the left side curves through a wooded area. A utility pole with multiple cross-arms and insulators stands in the middle ground. The sky is a mix of blue and orange, with the sun setting behind distant hills. The trees are silhouetted against the bright sky.

Thank you

