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Warwick Anderson
General Manager
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Dear Warwick,

Ausgrid welcomes the opportunity to make a submission on the Australian Energy Regulator's (**AER**) information paper for the rate of return (**information paper**). 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 2022 Rate of Return Instrument (**RORI**) is occurring during the transformation of the energy sector, with changes in the national electricity market over the next 5 to 10 years likely to have long term impacts for customers. The next few years will be critical, as the pace of transition of the energy sector increases, and the window for efficiently transitioning the sector through prudent and well-timed investment closes. For example, over the coming years there is a 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 important for networks, as global mean temperatures continue to rise.

The ENA submission, supported by Ausgrid, provides more technical detail on all the issues, however we make some brief comments below on the key topics raised by the AER in the information paper.

**Term of the risk-free rate should remain at 10 years**

The AER notes the rationale for potentially changing the term of the risk-free rate from 10 years to 5 years would be that it satisfies the NPV=0 principle as defined by Dr Lally, and would be consistent with the change to a 5 year term for inflation.[1] Ausgrid considers that this rationale is flawed.

In its 2018 RORI, the AER decided that the NPV=0 criterion was met by providing compensation for efficient financing costs.[2] A 10-year term was considered appropriate because it is consistent with the Sharpe-Lintner Capital Asset Pricing Model (SL-CAPM) and reflects actual practice of investors, thus meeting the NPV=0 criterion. It was also recognised that it is well accepted in the academic literature. The AER was also aware of Dr Lally's views on a 5-

[1] AER, Rate of return – information paper and call for submissions, December 2021, p 17.
[2] AER, Rate of return instrument explanatory statement, December 2018, p 35.

year term satisfying the NPV=0 criterion, however despite this continued to apply a 10-year term.

It is not clear how the evidence has changed since 2018 to prompt such a significant methodological change. The term of inflation is unrelated to the term of the risk free rate. Indeed, the term of debt, term of equity and term of inflation do not need to align because each is performing a different task in the regulatory framework.

**More weight should be given to dividend growth models (DGM) when estimating market risk premium (MRP)**

The information paper notes that the AER has narrowed its focus to three potential options to estimating MRP:

- Maintain current approach, which is to give a primary role to historical excess returns (**HER**) considering both geometric and arithmetic means;
- Use estimates from DGM to inform the point estimate of MRP within the range of the current approach; and
- Provide more weight to DGM alongside current approach.[3]

Ausgrid believes the third option is the most reasonable option. The first option gives no material weight to DGM or other methods of estimating MRP. This implicitly assumes that MRP does not vary over time, because HER estimates are effectively constant over time. It was generally agreed by the expert panel that MRP does vary over time, and the AER's consultants CEPA advised that MRP is time-varying.[4] Therefore, it would not seem consistent with advice from all experts consulted by the AER to rely almost solely on HER.

The second option seems like it would use the DGM to indicate which historical averaging period to use from the range of HER estimates. That is, there are a number of time periods over which the HER is calculated that results in a range of estimates. Using DGM to choose an estimate from within that range means that if the DGM is low, it may indicate use of a HER estimate from a particular year that is at the lower end of the range. If it is high, it may indicate a HER estimate from a different year in the higher end of the range. Selection of the HER estimate should be based on the AER's assessment of how appropriate the data of each averaging period is in informing the future expectations of investors, independently of the DGM estimate of MRP.

The third option allows the AER to bring the HER and DGM methods together in a complementary way. The HER method provides evidence about the long-run average MRP based on the AER's assessment of the most representative time period. The DGM is then used to signal whether the prevailing MRP is higher or lower than the long-run average and by how much. The AER would apply its regulatory judgement as to the weight to apply to each.

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[3] AER, Rate of return – information paper and call for submissions, December 2021, p 20.
[4] CEPA, Relationship between RFR and MRP, p 13.

**International data should be included in the equity beta estimate**

The AER's preliminary position is to maintain its approach in the 2018 RORI when estimating equity beta.[5] This means the current comparator set of firms will continue to be used, even though only one of those firms will be active when the 2022 instrument is made. As explained in our submission to the equity working paper, we believe this is insufficient to provide a robust data set for the purpose of calculating equity beta.[6] The relevance of the obsolete firms to rates of return that will be set in regulatory determinations up to 2031 is negligible.

Consistent with our previous submissions, Ausgrid strongly encourages the AER to consider bringing international data into its analysis to broaden the small data set and improve the robustness of the results. The challenges of using international comparators are not insurmountable, as discussed at the expert session on this topic. Data can be adjusted for country-specific industry weights and differences in gearing, and there is precedent for doing this from other similar regulators.

**Current debt methodology is appropriate**

Through use of the energy infrastructure credit spread index (**EICSI**) the AER has determined that after normalising for credit rating and term, there is a modest residual outperformance of around 4 basis points (bps).[7] In the expert session the AER noted there was a standard error of 15bps around this outperformance. This indicates the current methodology is working well and there is no basis for any adjustment for residual outperformance.

Term has been identified as a possible driver of outperformance.[8] There does not appear to be a compelling case for lowering the term from 10 years based on the weighted average term to maturity at issuance (**WATMI**) data. As discussed in previous submissions[9], Ausgrid's average debt issuance is lower than 10 years due to the lease transaction which necessitated progressive refinancing more in line with the efficient debt strategy of an infrastructure business. However, issuance tenor has been increasing as Ausgrid's debt is progressively refinanced over time and the debt maturity profile evolves. Other businesses may have particular reasons for tenor to vary from the benchmark at any particular time. On this basis, we don't agree that WATMI can be used to deterministically set a benchmark term unless the drivers are fully understood, and there appears to be a material and sustained deviation from the benchmark term. This is not evident currently.

**Weighted trailing average return on debt**

Ausgrid does not advocate implementing a weighted trailing average return on debt. The complexity and implementation issues appear to be significant, and there may be other ways to assure the financeability of major projects that may be explored in the AEMC's Review of Transmission Investment Frameworks. If the AER decides to pursue a weighted trailing average

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[5] AER, Rate of return – information paper and call for submissions, December 2021, p 22.
[6] Ausgrid, Submission – Equity, 3 September 2021, p 6.
[7] AER, Rate of return – information paper and call for submissions, December 2021, p 25.
[8] AER, Rate of return – information paper and call for submissions, December 2021, p 26.
[9] For example, Ausgrid, Submission – Debt, 3 September 2021, p 4.

return on debt, it should only apply in instances where there is expected to be a material increase in the RAB.

**RAB multiples a useful cross-check only if the regulated element can be disaggregated**

It is generally accepted that RAB multiples are affected by revenue streams unrelated to the regulated asset base. On this basis, it is impossible to know how much of a RAB multiple can be attributed to the RAB and how much to unregulated parts of the business. Unless the RAB multiple can be disaggregated into the regulated and unregulated components, it is not possible to infer whether regulatory allowances under the rate of return can be deemed adequate.

**Financeability**

We agree with the AER that financeability tests should be part of the suite of cross-checks. We re-state our implementation suggestion from a previous submission below:

> The AER has been provided with a version of the PTRM that contains relevant metrics, which could be built into the standard PTRM.[10] The AER would assess all metrics and determine whether the quantitative score aligns with the levels generally used for the credit rating of the benchmark efficient entity. 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.
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> If it is evident that the RORI would produce metrics inconsistent with the benchmark credit rating, the AER would revisit elements of the rate of return where it has used judgement and amend such the metrics are consistent.[11]

If you have any questions regarding this submission, please contact Fiona McAnally

Regards,

Rob Amphlett Lewis
Chief Customer Officer

[10] These were submissions made in the recent Victorian regulatory decision process.
[11] Ausgrid, Submission – Overall rate of return, 3 September 2021, p 6.

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