Ausgrid Submission

Term of the rate of return

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Dear [redacted]

Ausgrid welcomes the opportunity to provide this submission to the AER's working paper on the term of the rate of return. 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.

While the various terms used in the regulatory framework seem to have been settled through many previous reviews and decisions, we understand that the AER may wish to reconsider some topics to reassure itself that those previous decisions remain valid.

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 at 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 agrees with the AER's initial assessment that the term of inflation does not need to match the term of the rate of return, nor do debt and equity by definition need to have the same term. Further, we support at least maintaining the 10 year terms for both debt and the risk free rate.

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

Yours sincerely

[redacted]
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 international peers. While reductions in the risk free rate have contributed to this, the key issue is the historically low equity risk premium applied in the 2018 RORI. The ability to attract investment is increasingly difficult, and the possible changes being investigated by the AER and raised in the Term of the rate of return 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.

Our submission responds to the questions regarding matching terms, then discusses the term of debt and term of equity respectively. Ausgrid also supports the ENA submission, which provides more detail on some of the matters raised in this submission.

Matching of terms

The working paper asks several questions about whether the various terms used in the regulatory regime need to match with one another or the regulatory period. The table below summarises Ausgrid's position on these questions.

Question	Position
Should the term for expected inflation match the term for the rate of return?	Agree with AER preliminary position that the terms do not need to match. The estimate of inflation is used to adjust revenues within a five year regulatory period, so it is appropriate that this is based on a five year term. The rate of return should be based on the efficient return required by investors for long term assets.
Should the term for equity match the term for debt?	Agree with AER preliminary position that the terms do not need to match. Terms for both debt and equity should be based on the efficient return required by investors for debt funding long term assets and equity funding long term assets.
Should the term for the return on equity align to the regulatory control period (typically five years) or a longer period more consistent with the life of the underlying asset life (e.g. ten years)?	Term of return on equity should be at least 10 years. See return on equity section below for reasoning.

Return on debt

Accepting the premise that the debt term should be independently assessed and not linked to any other term, the next question is the appropriate term of debt. This is linked to the form of debt, which is a currently trailing average. The AER's preliminary position is to maintain a trailing average, and Ausgrid supports this view. This was implemented with a very strong evidentiary basis in 2013 and remains the most appropriate methodology based on management of an efficient debt portfolio. Whilst it is not part of this submission, Ausgrid would welcome the opportunity to provide feedback on the appropriate benchmark index for the efficient debt portfolio. The next question is the term over which the trailing average is calculated.

The AER is considering using the weighted average term to maturity at issuance (WATMI) derived from the debt data collected from network businesses over recent years, rather than 10 years as used in previous decisions. Ausgrid's concerns with this approach, including some methodological issues, were raised in our submission to the energy network debt data paper[1]. While some calculation methods have improved based on feedback from industry, three key issues remain:

- Factors affecting actual debt outcomes
- Circularity
- Transparency.

Factors affecting actual debt outcomes

Businesses that have been subject to a recent transaction are generally moving towards an efficient debt portfolio after starting from a position of 100% short term bank debt. It will take a number of years for these businesses to replace that debt and implement efficient, long term strategies that eventually achieves a WATMI of 10 years. This should be considered when interpreting the WATMI.

Apart from transactions, other demand side factors affect issuance tenor which may result in a business issuing shorter dated debt in one period and longer dated in another period. This could be driven by varying conditions in debt markets which can affect multiple businesses so as to have a material impact on the WATMI in a particular year or over several years.

Circularity

The EICSI, having a composition that is relatively low in number and of a diverse range in size, lacks the breadth required to be a reliable index. This raises issues of equity and independence. By forming a nexus between the benchmark and the financing activity driving it, there could be the potential for networks to influence the benchmark outcomes which would compromise the benchmark regime.

Transparency

The data underlying the EISCI and WATMI is highly sensitive and confidential. The ability of networks to forecast medium to long term debt costs with any degree of comfort if term was to change at each RORI would be lost. Financial forecasts are used to assess credit ratings and an added layer of uncertainty in the forecasts would have implications on how the sector is evaluated. Currently, a 10 year forward yield curve can be used to estimate long term benchmark debt costs, but there is no way to know how the WATMI might move over time as it will be influenced by the financing decisions of other networks. Further, other stakeholders will also find it difficult to understand how the debt costs might move over time.

It is not clear whether these concerns have been considered by the AER in its subsequent papers, and we would find it useful for the AER to explore these issues in detail in the debt omnibus paper.

[1] Ausgrid, Submission to Energy network debt data working paper, 14 August 2020.

Ausgrid considers that the WATMI is a useful tool to observe whether the 10 year term remains a reasonable estimate of the efficient debt term. However, it should only be used to change the debt term if it shows a material and sustained departure from a 10 year term over several years. Notwithstanding the above issues, the ENA has provided evidence that the WATMI is near to 10 years based on the data collected, therefore there does not seem to be a reasonable basis on which to change the benchmark debt term.

Transitional arrangements

The AER asks what transitional arrangements would be required if there was a change to the term of debt. Based on our view that the term should not change there would not be a transition issue to consider. However, we suggest that a transition to a change to term would require careful consideration and be based on a methodology that is replicable by businesses. The costs and benefits of implementing a transition, which would add complexity and administrative burden for both businesses and the AER, should be considered as part of the decision to change the term.

Return on equity

5 year term

The working paper raises the question of whether the term for equity should align with the term of the regulatory period, or a longer period more consistent with the long life of assets. Dr Lally provided advice suggesting that a 5 year term, aligned to the length of the regulatory period, satisfies the NPV=0 principle[2]. When the AER assessed this premise in 2018, it noted that the analysis was flawed because of the assumption that the value of the RAB at the end of the period is known at the beginning of the period[3]. In his latest paper Lally has refuted the AER's interpretation by explaining that the assumption relates to the expected value rather than the value known with certainty[4]. Ausgrid's view is that the analysis remains flawed in the context of application in the real world for a number of reasons which are detailed in the ENA submission.

Investor expectations

The case for a 10 year term for the risk free rate is compelling. The most obvious evidence is that utilities are long-lived assets and utilities equity investors invest for the long term matching the long asset lives. The weighted average asset life of network assets is far longer than 10 years, however 10 years is deemed the most reasonable proxy because there is not a reliable bond market of greater than 10 years in the Australian market. It has been demonstrated in all rate of return decisions that investors value long lived assets using a 10 year risk free rate, therefore the most efficient term to input into the rate of return, which matches with investor expectations, is the 10 year rate. This evidence has been evaluated as relevant previously and has not changed.

The AER has published its assessment of how it views the regulatory task of setting a rate of return in the context of the national electricity objective (NEO) and national gas objective (NGO)[5]. In this paper the AER stated that:

> *the NEO and NGO are best advanced by determining an expected rate of return that is both efficient and benchmarked across electricity and gas network service providers*.[6]

The evidence clearly shows that a 10 year term for equity aligns with this statement.

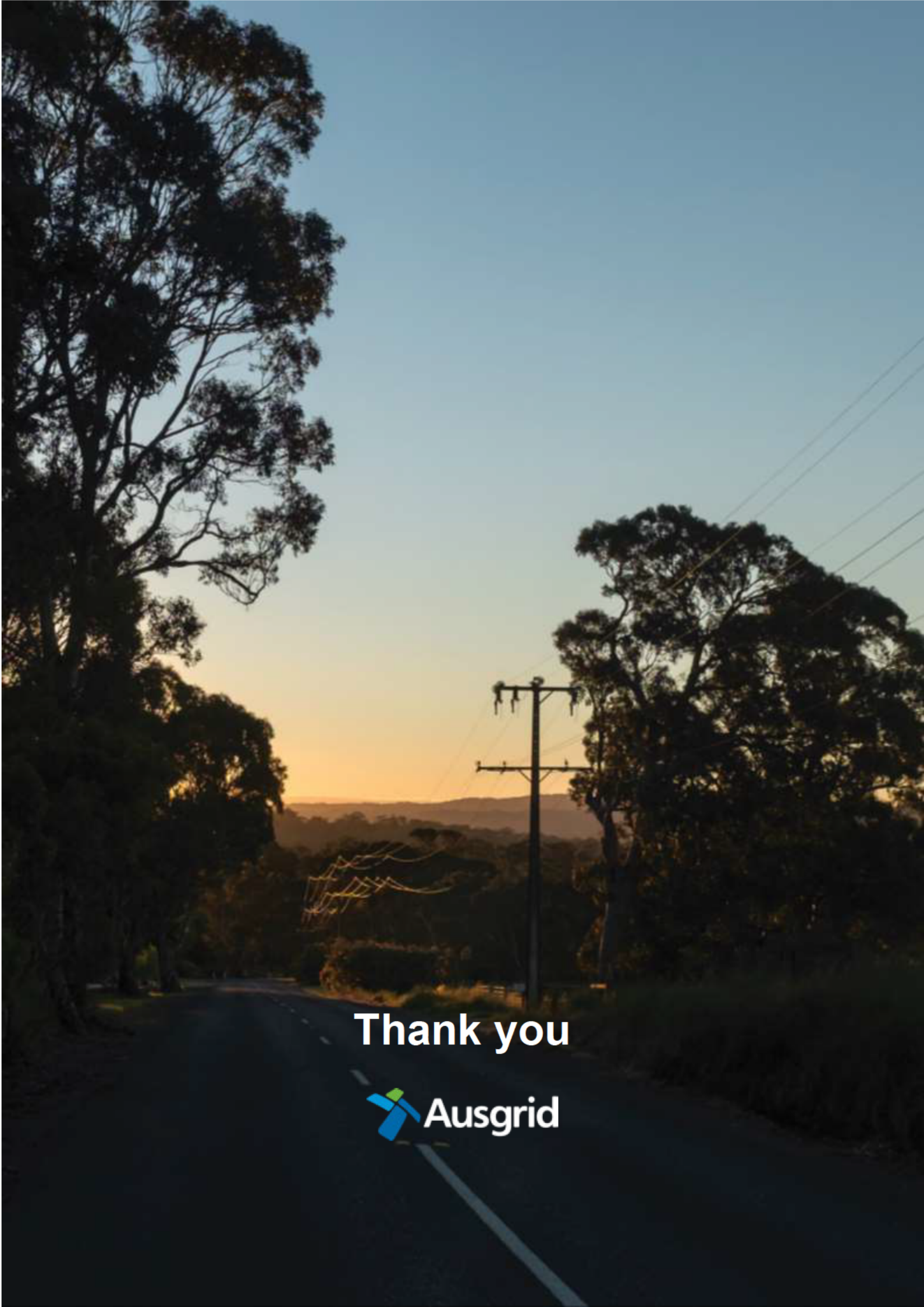
Comparison with other regulators

[2] Lally, The appropriate term for the allowed cost of capital, 9 April 2021, p 3.
[3] AER, Rate of return instrument | Explanatory statement, December 2018, p 130.
[4] Lally, The appropriate term for the allowed cost of capital, 9 April 2021, pp 8-9.
[5] AER, Assessing the long term interests of consumers | Position paper, May 2021.
[6] AER, Assessing the long term interests of consumers | Position paper, May 2021, p 7.

Apart from aligning to actual investor expectations and practice, the overwhelming majority of comparable regulators use a 10 year or greater risk free rate as demonstrated by tables 1 and 2 in the working paper[7]. The two regulators who use 5 years appear to be outliers and we would encourage the AER to investigate not only their reasons for choosing a 5 year term, but the full context of their rate of return decisions. This is because there may be other aspects to the overall decision which are associated with or offset the decision to use a 5 year term, but which do not apply in the case of this RORI.

For these and many other reasons the AER has decided in all its previous rate of return decisions that the evidence points to 10 years as the most appropriate term for risk free rate as a component of return on equity. Ausgrid supports maintaining a 10 year term.

[7] AER, Term of the rate of return | Draft working paper, May 2021, pp 19-21


Thank you
Ausgrid