AER Consumer Reference Group

CRG response to the
AER's 2022 Draft Rate of Return Instrument

CRG presentation to the AER's Public Forum

27 July 2022

CRG's preliminary position in response to the AER's Draft RoRI

Our final position will be set out in our written advice to the AER

Agenda

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1. CRG's overall perspectives on the Draft RoRI
2. Assessing the risks of 'bias' in the AER's overall draft rate of return (Draft RoR) decision
3. Identifying a range of other concerns and questions
4. Considering whether the RoR should be adjusted given 2022 ISP
5. Reviewing the role of cross-checks
6. CRG's preliminary conclusions

CRG's overall perspectives on the AER's Draft RoRI

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- **The AER has:**
  - Conducted a detailed and open examination of each of the RoR parameters
  - Generally focused on key issues, where opinions differ, and regulatory judgment is required
  - *Mostly*, sought consistency with its 2018 RoRI approach
  - Regularly engaged with the CRG on key issues
- **The CRG is currently:**
  - Assessing the AER's RoR judgment against the key regulatory principles and criteria
  - Considering the AER's draft RoR decision in the 'round' as well as at parameter level
  - Assessing the impact of 'current market conditions' on consumers and their usage of energy services
  - Undertaking further consumer engagement and additional technical research on RoR. We are particularly interested in:
    - The impact of recent energy market events on consumers' perspectives, priorities and behavioral choices

CRG's overall perspective (2)

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- The **CRG agrees with the AER that the 2018 RoRI is the appropriate starting point**
  - No evidence that 2018 RoRI decision has hampered investment in the networks
  - Consistency of approach -> greater investor and consumer confidence
- **The AER needs to further:**
  - Demonstrate more clearly its decisions are in the long-term interests of consumers
  - Consider:
    - Risk of an upward 'bias' when the RoR decision is considered 'in the round'
    - Coherence in approach across all RoR parameters
    - Role/weighting of 'current market conditions' in the RoRI
    - Allocation and mitigation of risk

And overall, we seek a change in the 'regulatory language' to focus more on consumer perspectives in the market

An 'unbiased estimate' of the rate of return

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CRG agrees with the AER when it states:

*"guiding principle is to determine an **unbiased estimate** of the expected rate of return consistent with the relevant risk involved in providing the regulated network services…We consider the NEO, NGO and long-term interests of consumers are best served through this guiding principle"*[1]

- The AER exercises its regulatory judgment at the parameter level – and at the overall RoR - to satisfy this guiding principle
- The AER's decisions on return on equity parameters and return on debt, suggest an upward bias in its interpretation of the data it uses in estimating:
  - Equity beta
  - Market risk premium (MRP)
  - Return on debt

The cumulative impact of individual parameter decisions on the overall RoR, is particularly significant for consumers at this challenging time

1. AER (2022) *Draft Rate of Return Explanatory Statement, (June, pp. 6, 31, 50, 59, 298)*

Sources of bias in the AER's regulatory judgments (1)

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Equity beta

- **The CRG agrees that beta estimates from international energy firms and non-energy domestic infrastructure firms should not be included in the data analysis for estimating beta**
- **The AER's draft decision on the equity beta (beta = 0.6) does not adequately reflect the limitations of current data and observed trends in this data. For example:**
  - Inclusion of *long* defunct energy businesses in the sample
  - Relevance of the data from businesses whose value includes returns from non-regulated network assets and other activities
  - Relies on estimates from 10-year history of returns, while acknowledging 5-year based estimates may contain relevant information
  - The observed beta for the *two most relevant network f*irms are consistently below 0.6, and the most recent (5-yr) beta estimates are below 0.4

The CRG questions whether the best estimate of beta should remain at 0.6

  - Change from current 0.6 is not inconsistent with the progressive decline in the AER's allowed equity beta estimates since 2013
  - The CRG is considering if 5-year beta data should have more weight, given change to a 5-yr term in the risk-free rate (RfR)

Sources of bias in the AER's judgments (2)

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Market Risk Premium (MRP)

- **CRG supports AER's preference to rely on Historical Excess Returns (HER) analysis of MRP - particularly in regulatory context - given the volatility of estimates from alternative approaches (e.g. dividend growth models)**
- **The AER's draft judgment (HER point estimate of MRP of 6.8%) is high relative to previous decisions. Potential sources of this increase include:**
  - Relying on the 'shortest' historical period (2018-2021)
  - Relying solely on arithmetic averages, despite acknowledging this will overestimate the true HER
  - Are there other factors driving increase from 6.1 to 6.5 (10-yr RfR) data)?
- **The AER's decision to change to a 5-year RfR further increases the MRP**

The CRG questions if the AER's draft estimate of the HER MRP (6.8%) uses *all* the relevant evidence

AER's MRP data set

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Historical excess returns (per cent) - 10Y term 2

Sampling period	Arithmetic average	Geometric average
1883-2021	6.4	5.1
1937-2021	6.2	4.4
1958-2021	6.7	4.5
1980-2021	6.8	4.8
1988-2021	6.5	5.1

Historical excess returns (per cent) - 5Y term[5]

Sampling period	Arithmetic average	Geometric average
1972-2021	6.9	4.5
1980-2021	7.1	5.0
1988-2021	6.8	5.4

AER states:

"Our value of 6.8% is consistent with the 6.1% used in the 2018 decision which corresponds to the arithmetic mean for 1988 to 2017" [3]

?

2. AER (2022), *Historical Excess Returns (XLSX)* (16 June)
3. AER (2022) *Draft Explanatory Statement* p.134

Sources of 'bias' in the AER's judgment (3)

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Return on debt

- **CRG supports the AER's decision to continue with the current 10-yr trailing average approach (TA) to debt – including no weighting for forecast capex profile**

- **'CRG also accepts the difficulty of directly translating the EICSI analysis to the estimation of the efficient return on debt. However**:
  - Annual review of the EICSI clearly demonstrates that the AER's annual estimate of debt costs is consistently above the actual reported debt costs[4] – average spread of 18 bp[5]
  - This benefit is not shared with consumers over time (i.e., it is not aligned with the AER's other 'incentive' schemes where benefits are shared with consumers over time)

- **The 10-year TA approach has consistently overestimated the prevailing debt costs** (independent of the EICSI observations) since 2014-15

The cost of debt trends are difficult to 'fix' directly but should still be considered as part of the AER's judgment on the 'best' overall RoR

4. See: AER (2022) *Draft Explanatory Statement* p. 201
5. AER (2022) *Draft Explanatory Statement* p. 207. This is the average basis point (bp) spread across the whole period of the EICSI data between the AER's annual estimate of debt cost (not trailing average) and the EICSI estimate, including impact of differences in term.

Other concerns, comments and questions (1)

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- **Conceptual coherence of the AER's Draft RoR Decision**
  - Requires careful consideration and consistent treatment of the consequences of the the AER's 5-yr term decision across all RoR parameters
  - Impact of the structure of the RoRI and its 'long-tail' impact on network revenues and on costs to consumers
- **Weighting on 'current market conditions'**
  - If 'current market conditions' are relevant to the AER's judgment, then…
  - the AER's assessment must *equally* consider current market conditions for investors *and* for consumers
- **Ensuring symmetry in approach and outcomes**
  - For example, if using financeability cross-checks – the RoRI must define over and unde-outcomes for each measure and how the AER will respond to both over and under returns
- **Risk assessment should be made from both investor and consumer perspectives**
  - Recognise the extent of the protections that consumers 'provide' (pay for!) to the regulated networks

Current energy market conditions for consumers are particularly difficult

Determining the lowest cost of capital consistent with the provision of the services consumers require needs to be central to the AER's judgment

Other concerns, comments and questions (2)

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We need to change the regulatory language to ensure a balanced decision with a focus on consumer outcomes

“Current market conditions for investors AND consumers”

“Risks to investors AND consumers”

“Risk mitigation funded by investors AND by consumers”

“Investors’ expectations AND consumers’ expectations”

“Efficient investment AND efficient utilisation”

Other concerns, comments and questions (3)

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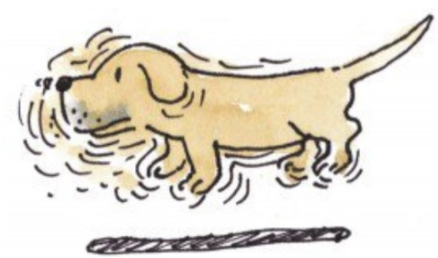
Tails wagging dogs

- **The RoR will apply to around $112B of sunk electricity and gas networks[6]**
- **The 'new world' will require significant investment in the transmission network**
  - 2022 ISP estimate of ≈$10 B new investment through to 2031[7]
  - State and Federal Government providing financial and other supports to NSPs
  - Potential for greater contributions from new generators (especially within REZ)
  - Rule changes to provide AER with greater discretion (e.g., accelerated depreciation[8]) and to speed up regulatory approval process
  - Network threats to use their monopoly position to deny/delay required transmission must be addressed by policy/rule reviews

The CRG does not support adjusting the 2022 RoR in order to achieve the ISP requirements



[6] See for example, AER (2021) *State of the Energy Market,* Chapters 3 and 5.

[7] AEMO (2022) *Integrated System Plan, Appendix 5 "Network Investments' (June 2022).* Estimate is based on AEMO's identified 'Actionable Projects', excluding projects being developed under the NSW *Electricity Infrastructure Investment Act 2020* (NSW*),* and due for completion before 2031 (Hume Link, Marinus Link and VNI West)

[8] See AEMC (2022), *Transmission planning and investment – Stage 2, Draft Report* (June 2022)

Other concerns, comments and questions (4)

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The role of cross-checks

- **CRG agrees with the AER that:**
  - Cross-checks are not determinative but can provide useful information to support the AER's judgment
  - Each of the proposed cross-checks have limitations
- **High RAB multiples indicate that the AER's RoR approach is not deterring investment**
- **Proposed financeability test (FFO/net debt) is too limited and ill-defined**
- **Scenario analysis can be useful to test extremes, but limited in scope**
- **Historical profitability contains information on expected versus actual outcomes and should be considered relevant information**

The CRG supports use of RAB multiples, scenario/sensitivity testing and historical profitability. If the AER introduces financeability tests, this will require substantially more analysis to define purpose and outcomes

Preliminary conclusions

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- The AER has followed a detailed process and has acknowledged the CRG's consumer research in its Draft RoRI
- The CRG supports using the 2018 RoRI as a base for the 2022 RoRI
- However, the AER's 2022 RoRI process to date has focused on individual parameters
  - **Important for the AER to assess the overall RoR against its 'guiding' principles**
- The CRG concludes the Draft RoRI, **taken as a whole**, is not consistent with:
  - The AER's guiding principles of an unbiased estimate of the RoR
  - Lowest cost to achieve the network services that consumers' require
- The CRG has identified a number of other areas for further analysis
- We encourage the AER to explicitly consider consumers' current circumstances and the impact of its decision on energy affordability

Consumer interests must be at the center

The decision should not add fuel to the current fire

Attachment

Attachment - Consistent trend for high RAB multiples since 2015

Figure 4-4 AER regulated NSPs - transaction and trading multiples