Overall rate of return

Initial network sector views

AER Stakeholder Forum, 4 August 2021

Draft Working Paper - Pathway to 2022 Rate of Return Instrument

Energy Networks Australia

How is the 2018 RoRI performing for customers?

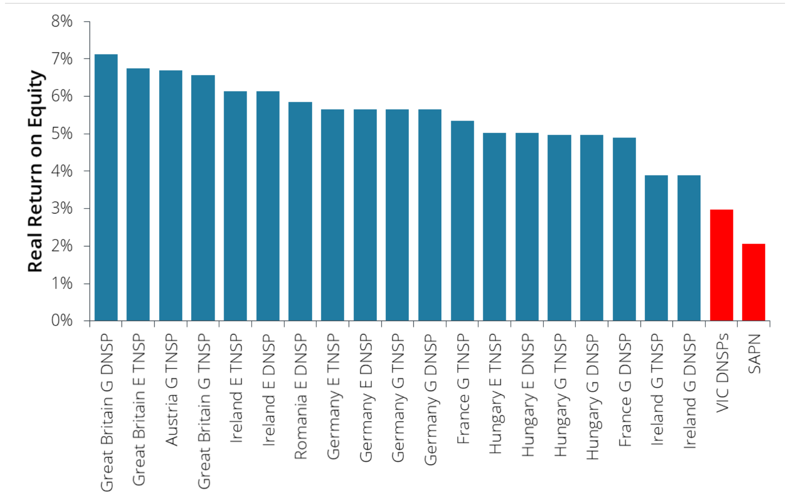
Has investment happened fast enough to meet customers' expectations and interests?

Current experience shows equity returns under the 2018 RoRI were insufficient to support investment

Situation

Currently have the highest ever private and foreign ownership in Australia's energy networks

2018 RoRI equity return is not internationally competitive

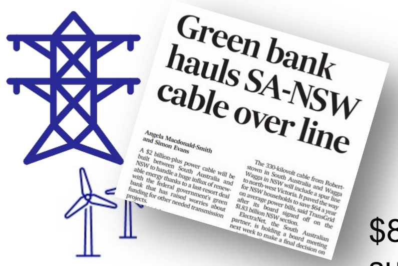


Among the **lowest RoE** allowed in any internationally comparable jurisdiction

Customer outcome

>> 75% of electricity customers and 100% of gas customers received their energy from a private network operator in 2021

>> Network investment to lower wholesale prices and maximise customers' value from their solar has not been timely or self-funding



$850m of govt subsidies needed to progress AEMO ISP projects

Households and businesses currently spend $3.5B pa installing solar

25% of households have solar

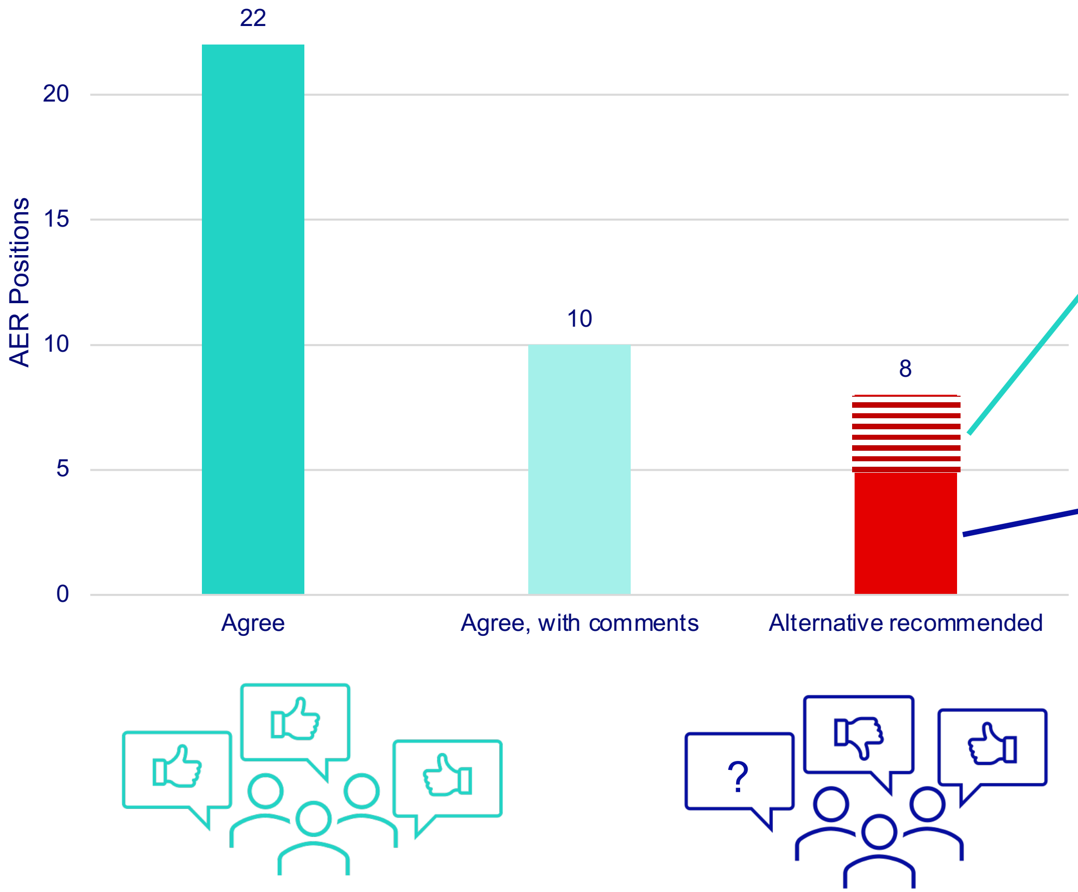
This risks being turned down or cut off.

Energy Networks Australia

We share significant areas of common ground

Networks' initial positions on 40 issues in AER's ORR paper table 1 show much has been resolved over past 3 RoR reviews and to date in this one

But the residual issues have critical impact that must be addressed given our experience under the 2018 RoRI



3 alternatives are simply retaining the 2018 status quo

1. 10-year equity term
2. EICSI is only a cross check for benchmark credit rating
3. If EICSI is appropriately specified, including tenor-weighted, it could be used to estimate an outperformance adjustment to the benchmark debt margin.

5 residual issues must be addressed

4. Use of CGS should be reconsidered
5. Supplement equity beta data set with international comparators
6. Have regard to DGM, weight to arithmetic mean, survey evidence when estimating MRP
7. Include all debt instruments that support credit rating
8. Apply a consistent approach to debt instruments across debt and gearing

Energy Networks Australia

Where do we agree but with comments?

	Issue	AER position	Initial network position
AER preferred positions	Low interest rate environment	The reduction in our return on debt has been in line with movements in the broader market for debt and the costs the regulated businesses face.	Agree. Noting that when term and value adjusted, network debt costs follow the AER benchmark closely.
	CAPM	Standard Sharpe-Lintner CAPM model used as the basis for determining the return on equity	Agree, noting that appropriate regard should be given to underlying weaknesses in the model where this is supported by evidence (for example, low beta bias).
	Risk free rate	Set the risk-free rate only at the beginning of each reset period	Agree, noting that either determining a more forward-looking MRP or acknowledging relationship with MRP may result in different MRP estimates at the time of a determination.
AER preliminary positions	WATMI	An updated WATMI, combined with the more detailed drawdown data, may be useful in determining a benchmark term	Agree. Benchmark term should follow empirical evidence where data indicates sustained change in commercial practice.
	Financeability	Measures of financeability are not used directly when setting the rate of return	Agree. Financeability is not proposed to be used directly, but as a cross-check to inform significant regulatory discretion in making the instrument, building on AER 2018 approaches.
	Cross checks - equity	Use cross checks to inform our overall return on equity point estimates	Agree. Support role for cross-checks to inform exercise of regulatory discretion (for example, re-evaluating highly uncertain parameter point estimates where cross-check suggest an issue may be present).
	Gearing	Consider adjusting gearing to more closely align with market data	Agree with adjusting if market data supports material change.
AER no position and seeking views	DGM	Consider if the dividend growth model might be used to inform the relationship between the MRP and risk-free rate	Agree, consistent with CEPA advice dividend growth models can and have been used by other regulators.
	Risk free rate/MRP relationship	Consider the potential for a relationship between the MRP and risk-free rate, and whether an appropriate implementation method is available	Agree. Appropriate implementation approach to be suggested.
	Cross checks - overall	Seeking views on the use of cross checks	Support role for cross-checks to inform exercise of regulatory discretion (for example, re-evaluating highly uncertain parameter point estimates where cross-check suggest an issue may be present).

What are the residual contentious issues?

		Issue	AER position	Position status	Network position
Case for change is not compelling	**Debt**	**EICSI** credit rating	Used to directly determine credit rating	Preferred	Use of EICSI to directly determine benchmark not consistent with a replicable benchmark. **Retain only as cross check**
		EICSI credit rating	Implement the EICSI by adjusting the weights of A and BBB data to match network cost of debt over the past four years	Preliminary position	If EICSI is appropriately specified, including tenor-weighted, it could be used to estimate an outperformance **adjustment to benchmark debt margin**.
		EICSI exclusions	Included only pure debt instruments in the EICSI, excluding hybrids, working capital and bridging loans, any instrument with a term under 12 months, and any instrument not used to finance the RAB	Preferred	**Include all debt instruments that support the entity credit rating**. Need to apply consistent approach to inclusion/exclusion across cost of debt and gearing estimates to produce a replicable benchmark allowance.
		Risk free rate term	5 or 10 years	No position – seeking views	**Retain 10 years**, consistent with long life of underlying assets
Change must be duly considered	**Equity**	**Risk free rate** proxy	CGS proxy for risk free rate	Preferred	**Matter should be actively considered** by the AER given evolving international practice, monetary policy interventions in government bond markets, and market conditions
		MRP	In determining the MRP, have regard to the historical excess return, both the arithmetic and geometric mean MRP, and MRP surveys	Preferred	In determining the MRP, **have regard to more forward-looking evidence** such as DGM estimates, with the arithmetic mean historical excess return is more relevant for informing the estimate. Take into account survey evidence on MRP, and matched risk-free approaches if surveys used.
		Equity beta	Use comparator set of nine Australian firms to estimate equity beta	Preliminary position	Use comparator set of relevant Australian firm data **supplemented with international comparators** to estimate equity beta.
		Gearing	Seek views on the inclusion of hybrid securities for gearing.	No position – seeking views	**Include all debt instruments that support the entity credit rating**. As above

Energy Networks Australia

How could the AER address these residual issues?

The AER have time to duly consider these issues

It will require a balanced, evidence-based approach

- **Engaging with expert evidence on these issues**
- **Adopting a robust approach to observed data**
- **Recognising risks of exercising judgment within a wide range**
- **Adopting best practice safeguards**

Our remaining slides give concrete examples for each of these tasks

Energy Networks Australia

Engaging with evidence on these issues

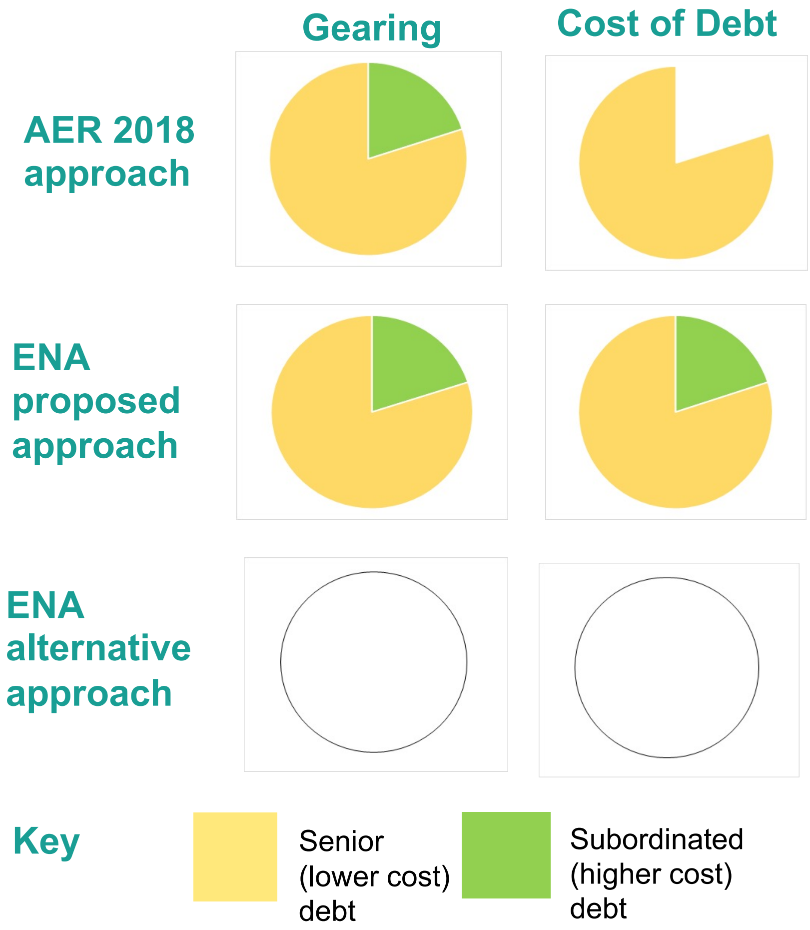
	Issues	Report	Findings or advice to AER
Equity	**Beta** **MRP**	Brattle August 2020 (for the AER) **A Review of International Approaches to Regulated Rates of Return**	• Allowed return on equity under the AER's current 2018 approach is lower than that adopted by every other regulator for which a comparison could be made (real, nominal, and equity risk premium) • Areas where AER's approach 'not as effective' as approach of other regulators include incorporation of forward-looking evidence in cost of equity, use of multiple models for estimating cost of equity, and 'beneficial' use of international beta comparators
	MRP	CEPA June 2021 (for the AER) **Relationship between RFR and MRP**	"…there is no good evidence that the MRP should be assumed to be independent of the RfR, the current implicit assumption of the AER's approach" "The international regulators that we examined do not rely on an estimate of the MRP that is wholly or even substantially based on the historic average of the realised MRP" • There are practical alternative approaches that can be applied with available data and these: "may provide a better estimate of the forward looking MRP consistent with the AER's duty."
	Risk free rate proxy	**UK Competition Market Authority findings – water appeals**, March 2021	Government bond yields are not the best unbiased estimate of the risk-free rate, consistent with the underpinnings of the CAPM, for two reasons: • Presence of a substantial measurable convenience yield associated with other valuable features of government bonds • Downward pressure of extraordinary monetary policy interventions and central bank bond purchasing on 'market' price of the risk-free proxy
	Risk free rate term **CAPM**	Lally April 2021 (for the AER) **The appropriate term for the allowed cost of capital**	• Market risk premium is not fixed over time
Debt	**EICSI** credit rating	Lally April 2021 (for the AER) **The appropriate term for the allowed cost of capital** ENA November 2020 submission	• EICSI outperformance appears mostly due to tenor, as industry has suggested • EICSI outperformance appears mostly due to tenor, not credit rating.

Energy Networks Australia

Adopting a robust approach to observed data

Several remaining issues need a consistent and principled approach to the data

For example, treatment of debt instruments and the equity beta sampling



Reaching a consistent position on Subordinated Debt

» Need **consistent treatment** across WACC parameters

» At a minimum, **debt classified as debt for both:**

  » **statutory accounting** (consistent with accounting standards, as verified via audit), and

  » **tax purposes** (by the ATO)

  should be treated as debt by the AER

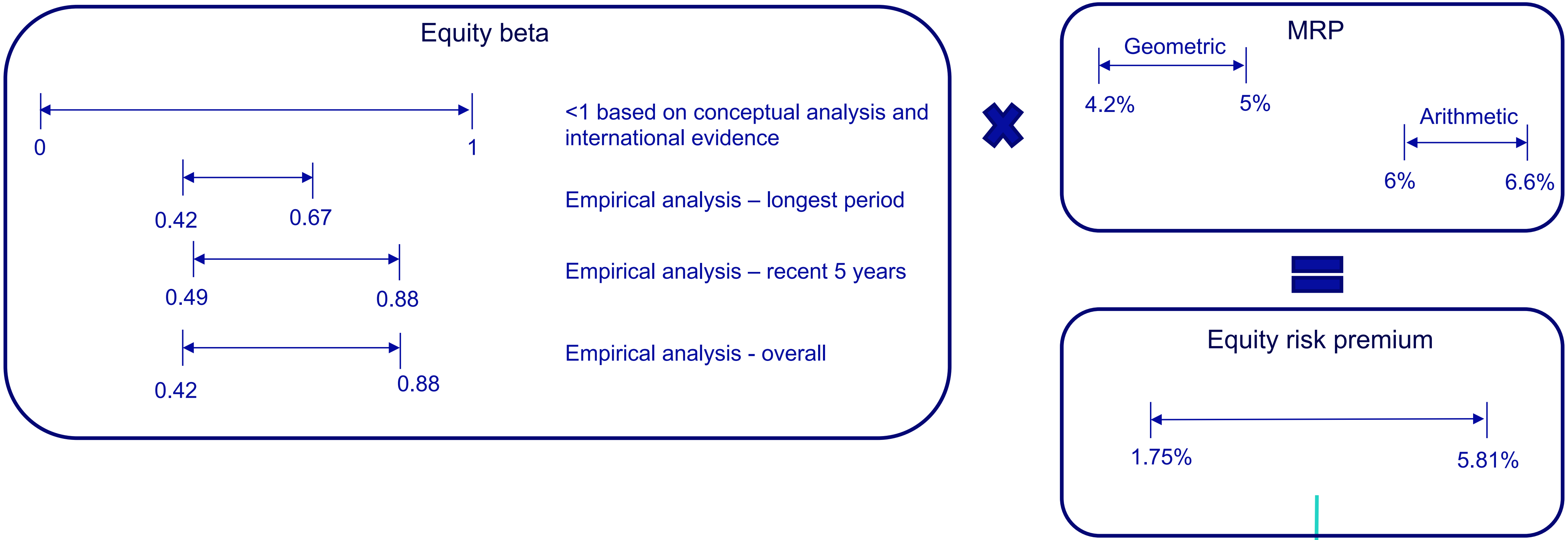
» Subordinated debt is an efficient part of the debt pie – a firm's debt should either be all included or all excluded from the AER's assessment

» Credit rating agency treatment of subordinated debt supports the issuance of senior (lower cost) debt – cannot look at one but not the other.

Exercising judgment within a wide range

WACC parameters cannot be estimated with precision (e.g., beta, MRP), the regulator applies judgment when selecting an estimate from within a wide range.

This is why cross checks are essential



Cross checks assist in providing an indication of whether the exercise of regulatory judgment has produced reasonable outputs. They are not intended to prove one model is better than another.

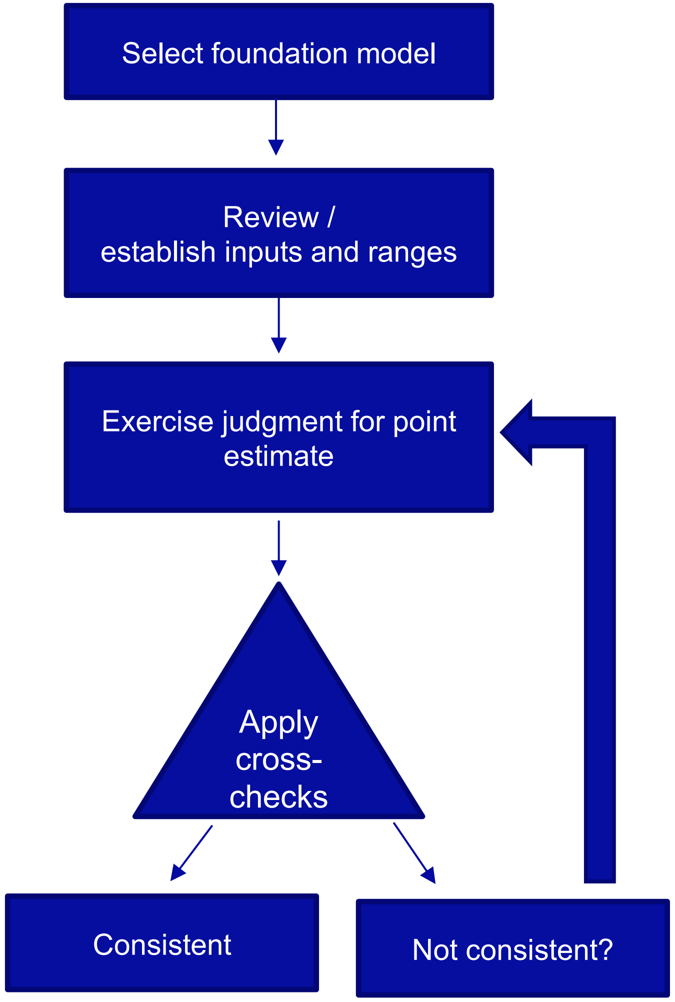
Energy Networks Australia

Adopting best practice safeguards

Applying cross-checks helps inform regulatory discretion

It's the 'belt and braces' part of ensuring a balanced outcome

- Cross-checks have a **valuable role to play** in informing the exercise of regulatory discretion
- All asset pricing models require complex discretionary judgements to parameterize and apply
- Cross-checks provide a means of ensuring the **outcomes of estimation uncertainty (wide ranges) and discretionary judgements on point estimates combine to produce a workable outcome for all stakeholders, including customers**
- At no stage in the cross-checks application are the cross-checks 'displacing' or overriding the foundation model → indeed, they are assisting its application
- Brattle identified that cross checks are a feature used in this way in several regulatory regimes
- ENA will put forward specific cross check suggestions in our submission and how they can be used.



Energy Networks Australia

Adopting best practice safeguards

Applying forward-looking financeability tests

A further 'belt and braces' part of ensuring a balanced outcome

- Welcome the AER being open to suggestions on how financeability could be used
- The limitations and issues of financeability testing raised by the AER previously were addressed in ENA's submission
  - ENA submission to this working paper will outline in more detail how we think it could work

Proposed approach

- **Undertake financeability tests building on past 2018 work**
- **Using a benchmark firm using credit metric calculations in PTRMs**
- **Check outcomes against established rating agency benchmarks**
- **If significant inconsistency is found, reconsider exercises of discretion in decision**
- **Recognise not all financeability issues will be resolved by RoRI adjustments**

Energy Networks Australia

ENA preliminary positions

Gearing

ENA agrees with the principle that the AER should use the best estimate based on the best evidence at the time of the relevant determination.

- **Subordinated debt securities should be included and used consistently within the framework**

Gamma

ENA supports continuation of the current methodology and further review of the ATO data.

Cross checks

Cross checks have a valuable role to play informing the exercise of regulatory discretion. We suggest they can be used to ensure that the outcome drawn from a wide range of estimates is reasonable, and will detail how they could be implemented in our submission.