Draft AER Rate of Return Instrument

Initial network sector views

AER Stakeholder Forum

27 July 2022

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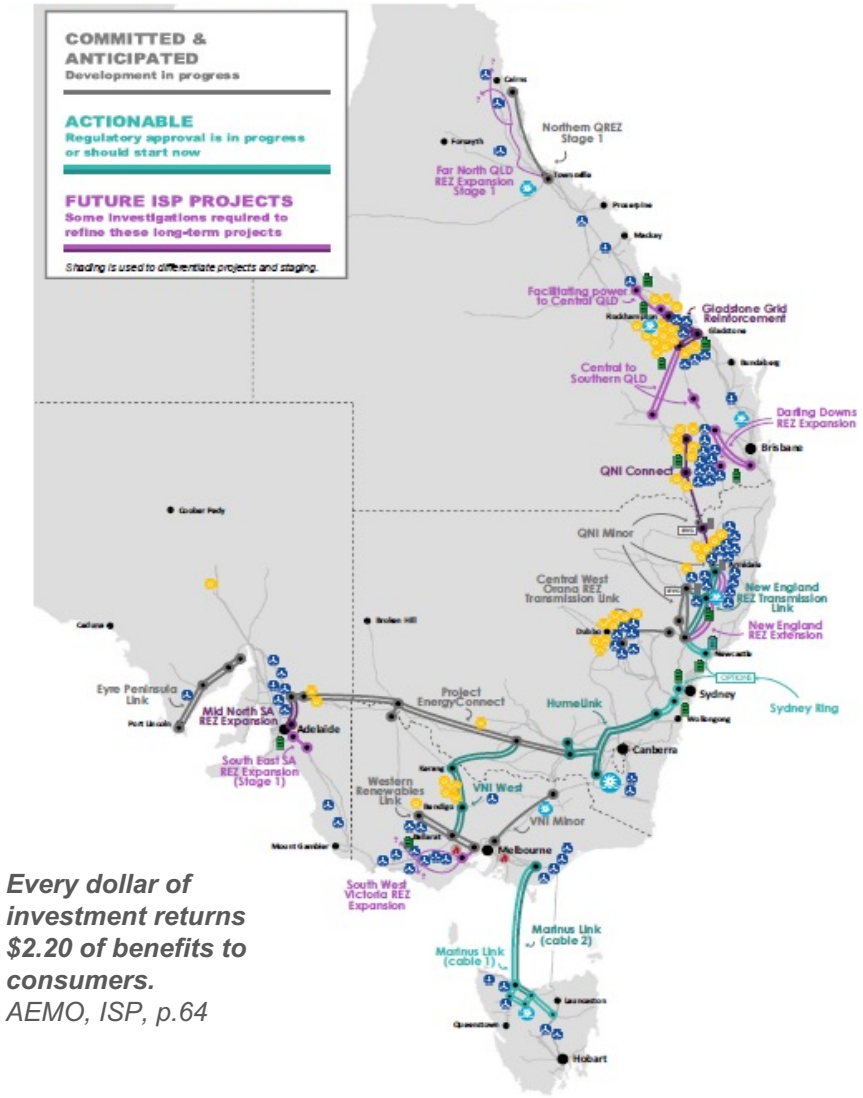
2022 RoRI will cover the critical period of Australia's energy transition



Every dollar of investment returns $2.20 of benefits to consumers.
AEMO, ISP, p.64

Map of the network projects in the optimal development path

It will underpin network investment until 2031. By then:

- at least 40% of current coal generation is scheduled to have retired;
- more than half of all customers are expected to have invested in DER;
- the grid will be capable of running at 100% instantaneous penetration of renewable energy, as per AEMO's target to achieve this by 2025

Significant network investment is required to:

- meet decarbonisation commitments,
- maintain reliable supply,
- enable customers to benefit from their behind-the-meter investment,
- lower wholesale prices

The Brattle report demonstrated that the AER's return on equity allowance was lower than that of comparable regulators. The AER now proposes a *further* reduction.

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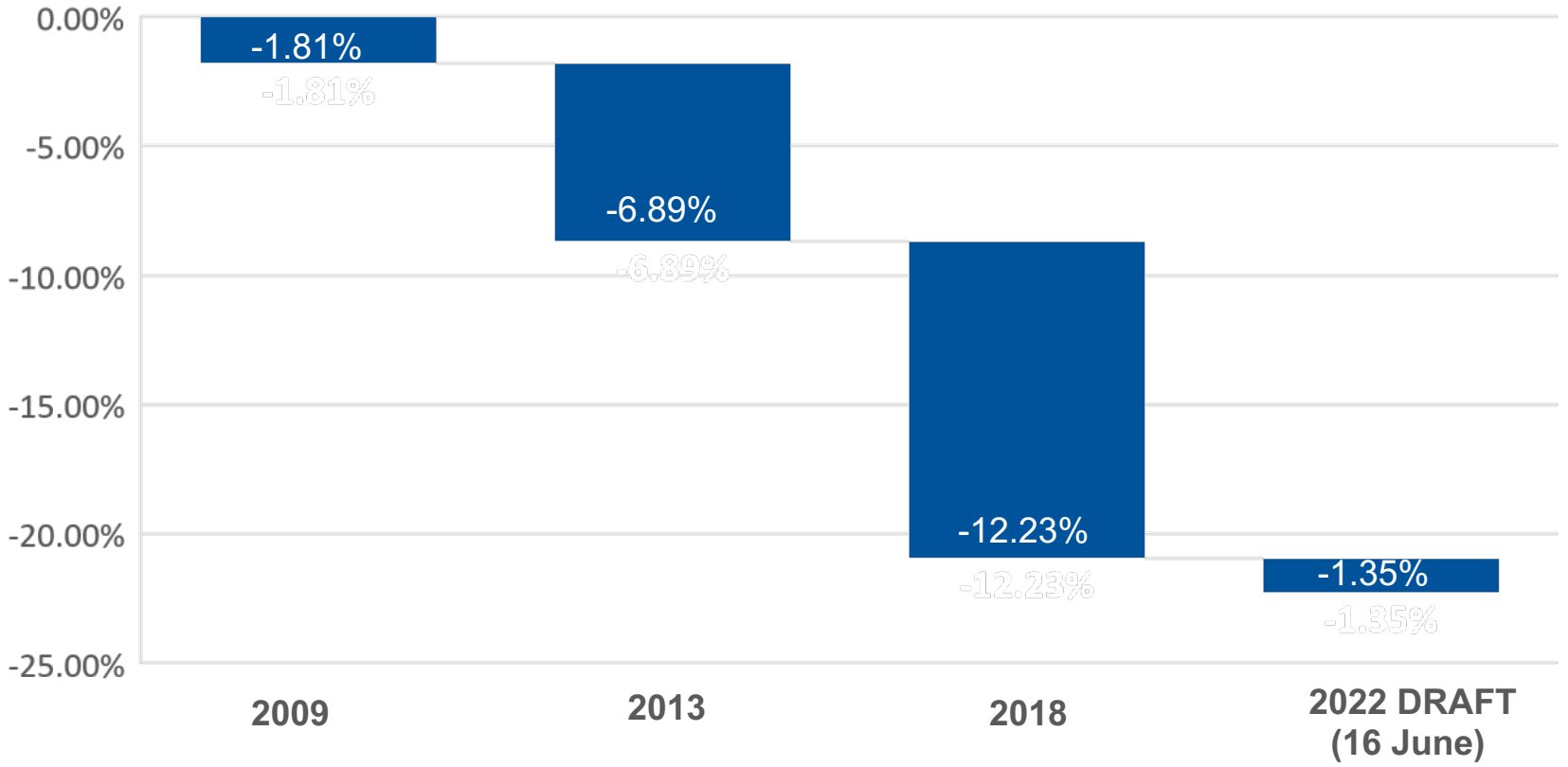
A further reduction in allowed returns – how low can we go?

In every WACC review, the AER has reduced the allowed return on equity relative to its previous approach.

Percentage change in equity returns in each AER review of the Rate of Return



This takes Australian returns further below international comparators when investment in Australia's energy transition is required to deliver net zero and associated customer benefits

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Problems with the 2018 RoRI are exacerbated by the 2022 draft

The 2018 RoRI was **not robust to the market conditions** that eventuated.

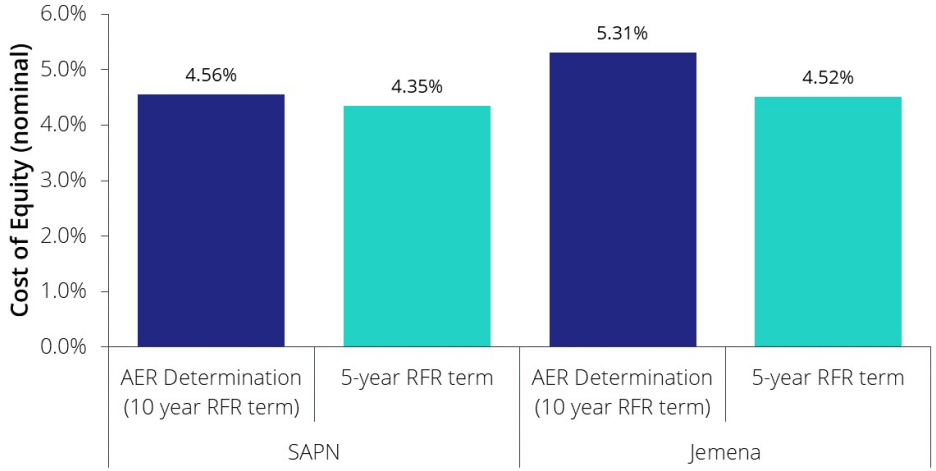
The 2018 RoRI **produced uneconomic allowances in 2020** determinations:

- Negative allowed profits.
- Negative cash allowance to equity.
- Not enough cash allowance to even pay the benchmark interest bill.

The draft 2022 RoRI **reduces the 2018 allowance further** and is **less robust** to unusual market conditions driven by the AER's proposed change to a 5-year term.

Equity returns provided since 2018 would have been materially lower under the draft 2022 RORI...

..including the SAPN and JGN 2020 decisions



What does this mean for customers?

The 5-year term results in **higher customer prices during severe financial crises and recessions** – when the 5-year CGS yield rises above the 10-year yield.

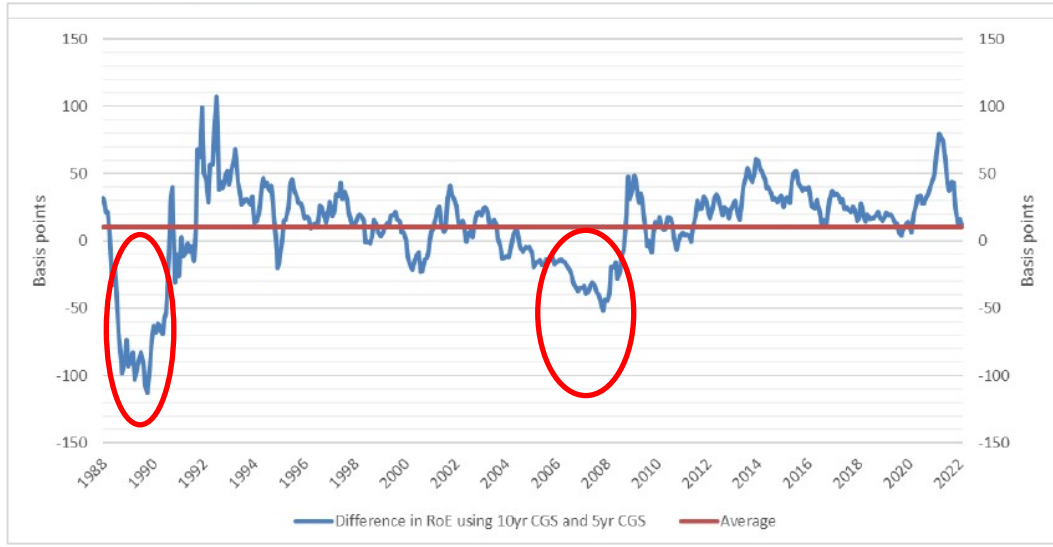
Higher prices during recessions and financial crises in which customer capacity to pay may be most under challenge.

Consumers are the beneficiaries of required record network investment.

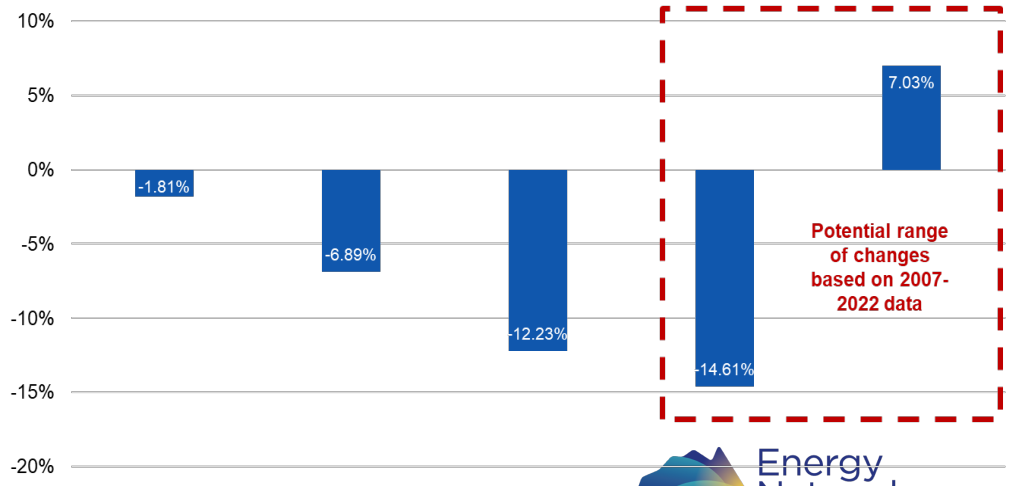
But **investors cannot see clear reasons for the proposed change** to a 5-year risk-free rate:

- Not just the current impact on allowed returns; but also
- Confidence in the AER and its regulatory process:
  - change is contrary to all commercial and regulatory practice and evidence;
  - reasoning is the opposite of that adopted in all previous AER decisions and December 2021 *Omnibus Paper*;
  - rationale for proposed change is flawed and has been rejected by the AER many times before.

Difference between return on equity based on 5-year and 10-year CGS yields, 1988 to 2022



Impacts of Rate of Return decisions (2009-2022) - % change to equity allowance



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The proposed term for the risk-free rate is contrary to commercial and regulatory practice

The nature of the proposed reduction (5-year risk-free rate) is:

- **Contrary to every decision made by the AER since its inception.**
- **Contrary to clear evidence about the practice of real-world investors**.

  There is overwhelming evidence that investors use a 10-year risk-free rate:

  - Market practice
  - Independent expert reports
  - Leading textbooks

Contrary to the AER's approach to debt

NPV=0 is achieved by setting the allowed return to match what investors require (the market cost of capital).

Contrary to the practice of every other Australian regulator.

The proposed change was driven by the AER and not stakeholders.

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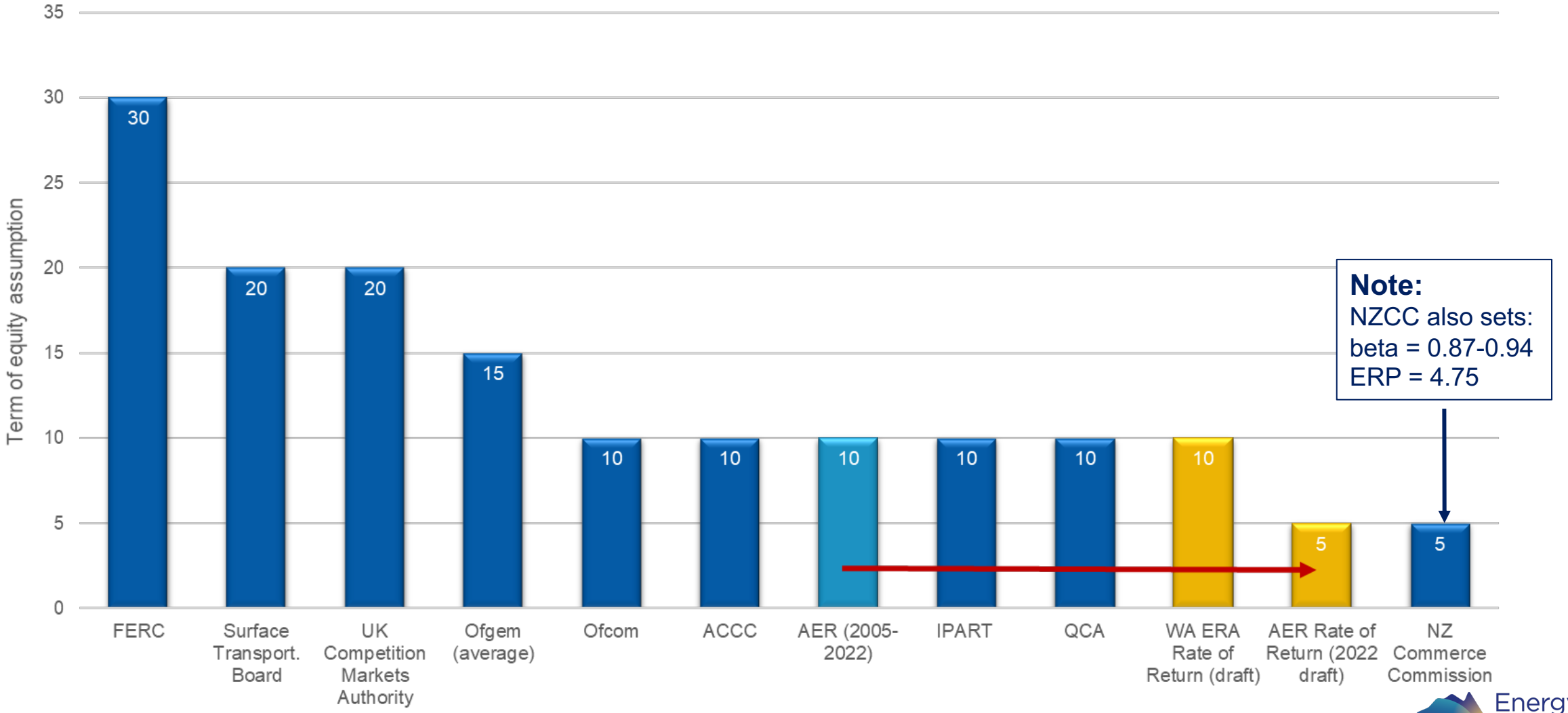
The AER is moving from mainstream practice at a time network investment is critical: what message is this sending to investors?



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Why now?

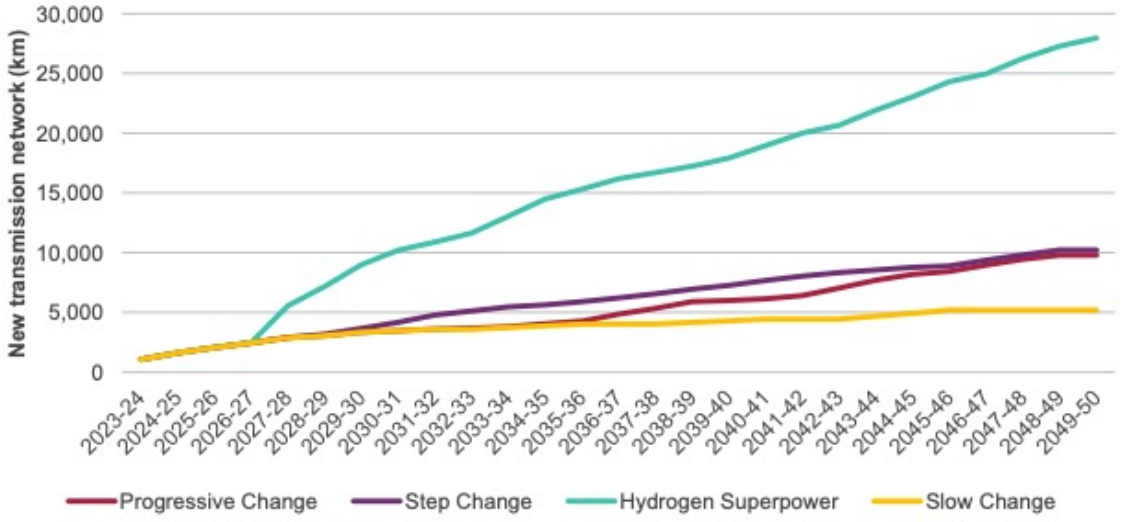
The AER has considered the same issue in every decision since its inception.

The AER has always rejected that submission and set the allowed return to match the market cost of capital – what investors actually require, not what someone thinks they should require.

- Is it the right time to pursue a lowering of allowed returns?
- Driven by the AER rather than stakeholders?
- Just when record network investment is required?

Impacts on predictability and regulatory confidence

New transmission network investment required in AEMO's ODP



Why the change?

Rationale 1 — The AER's regulatory task is different from the commercial task

- NPV=0 requires that a 5-year RFR must be used, otherwise investors will receive more than they need.
- Implies previous AER's were, and other Australian regulators are, performing the wrong task.

Previous AER decisions

- NPV=0 requires the allowed return to equal the market cost of capital.
- 10-year term is consistent with CAPM and commercial practice, and best promotes the NEO and NGO.

Draft RoRI

- NPV=0 does not depend on the market cost of capital
- 5-year term should be sufficient for equity investors
- (But not for debt)

Rationale 2 — The inflation and equity terms must match

'Consistency' requires that the term for inflation must match the term for equity (but not for debt).

Final Omnibus (December 2021)

- Inflation and rate of return perform different roles so there is no link between terms.

Draft RoRI

- Consistency now requires that the term for inflation must match the term for equity.
- (But not for debt)

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Rationale 1: NPV=0

A 5-year RFR should be sufficient for investors

NPV=0 requires that the allowed return matches the market cost of capital – the return that real-world investors actually do require, not what the AER thinks they should require.

Lally claims that Schmalensee (1989) shows that NPV=0 requires term matching.

- Schmalensee says otherwise: NPV=0 requires the allowed return to match the real-world required return.

The AER develops its own maths:

- Purports to show that, if investors really do require a 10-year return, there is no way for the AER to set an allowed return to achieve NPV=0.
- This is incorrect. If investors require a 10-year return and the AER allows that, of course we have NPV=0.

The weight of the evidence does not support the reduction in term ... which is more likely?

- All previous AER decisions have performed the wrong task.
- Majority of other regulators are performing the wrong task.
- Network investors (and independent experts) are using the wrong risk-free rate.
- Schmalensee (MIT professor) is wrong about the maths.

Or..

- The maths relied on in the current AER analysis does not actually support the proposition that investors should be happy with a 5-year risk-free rate.

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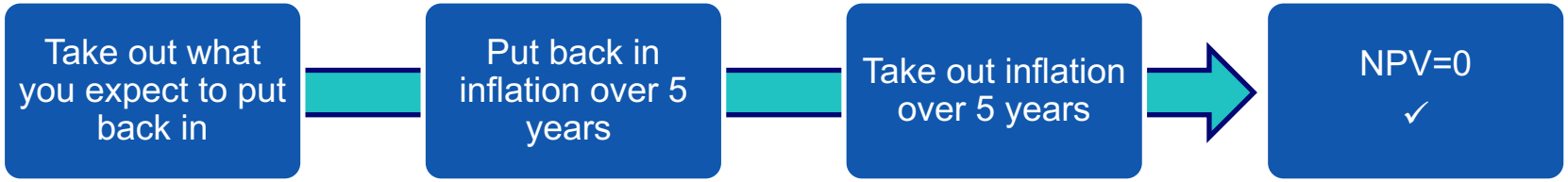
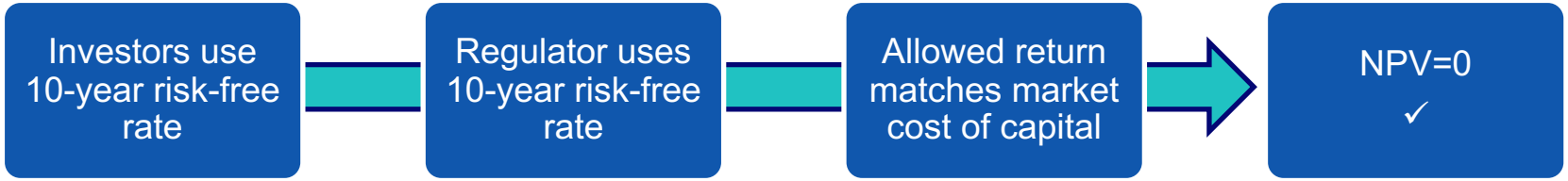
Rationale 2: Consistency with regulatory inflation

Regulatory inflation



Allowed return on equity



What has happened since Christmas?

The term for expected inflation and the term for the rate of return should be **independently** assessed and do not need to align with each other.

Preferred position is that the terms of equity, debt and inflation **do not have to be the same**.

Matching the equity term to the length of a regulatory control period would promote **consistency** with our decision on the term of the expected inflation.

??

AER, May 2021, *Term of the Rate of Return: Draft Working Paper*, p. 32.

AER, Preferred position as at December 2021. June 2022, *Draft rate of return instrument: Explanatory statement*, p. 40.

AER, June 2022, *Draft rate of return instrument: Explanatory statement*, p. 113.

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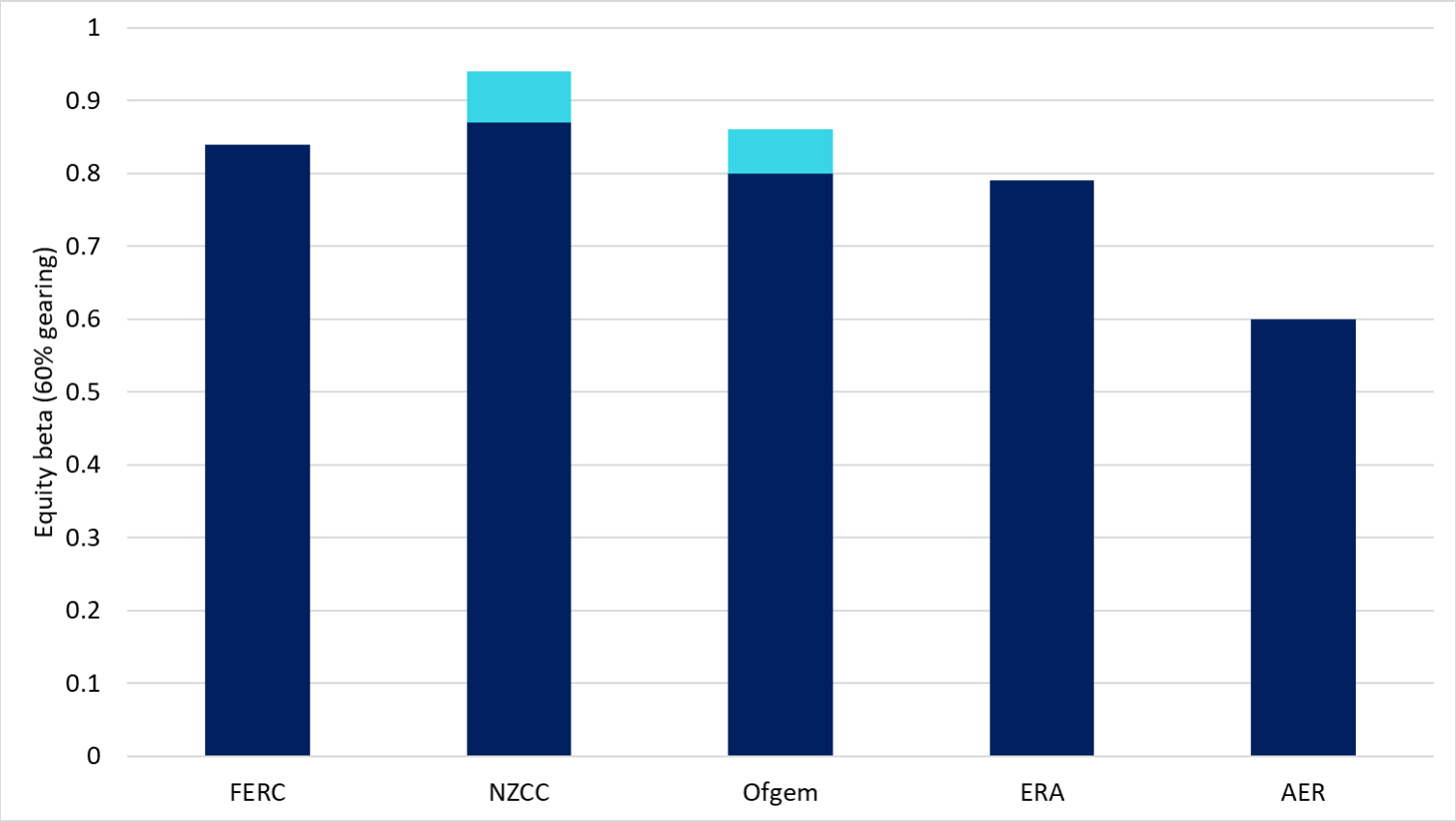
Equity beta is also lower than all other regulators



? Are AER regulated networks really so much less risky than all others?

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Market Risk Premium: Any DGM must be unbiased

The AER continues to prefer the Historical Excess Returns (HER) estimate on the basis that investors will expect/require a future MRP in line with what has been observed in the past, on average.

However, the AER DGM generates average estimates materially below the HER figure.

Its use would result in an allowed MRP systematically below what has been observed in the past.

This introduces a bias and breaches NPV=0.

A necessary condition for relying on a DGM is that it must produce an unbiased MRP – consistent with the AER's rationale for preferring the HER estimate. The calibrated DGM is (by definition) an unbiased approach.

- The AER identified two key problems in the 2018 RoRI, such that the AER-DGM received zero weight.
- ENA developed the calibrated DGM in good faith to address those problems.
- The AER has rejected the calibrated DGM and now favours the specification that was fatally problematic a few years ago.

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Allowed return on debt

ENA agrees that a 10-year trailing average, using data provided by independent third-party sources, provides an appropriate estimate of the benchmark cost of debt.

Networks and consumers both benefit from matching the allowance to efficient costs and from stability over time.

The consultation on EICSI ended with the conclusion that the current approach is within 4 bps of the actual cost.

An important example of why proposed changes require a long lead-time for proper consultation.

ENA continues its strong support of the trailing average approach – as a match between the allowed return and the efficient cost.

Provides smoothing benefits for networks and customers – the recent uptick in interest rates will not be matched by an immediate increase in the debt allowance.
This puts downwards pressure on prices.

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The CEPA RAB multiple disaggregation exercise

The AER engaged CEPA to determine how much of the Enterprise Value in the AusNet and Spark transactions is attributable to the regulatory allowance on the existing RAB.

But:

- CEPA deducts $370 million for AusNet's (unregulated) Development and Future Networks business.
- The Grant Samuel IER values that same business at $3,150 million

Correcting this problem reduces the RAB multiple to **1.06**, below any credible threshold for inferences to be drawn.

The Independent Experts' view is that the market cost of equity is materially higher than the AER's regulatory allowance.

	2018 RoRI approach	KPMG low	KPMG high
Risk-free rate	1.73%	2.80%	2.80%
MRP	6.1%	6.0%	6.0%
Equity beta	0.60	0.73	0.83
Return on equity	**5.39%**	**7.17%**	**7.76%**

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Thank you

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