2 July 2021

[redacted]
General Manager, Networks Finance and Reporting
Australian Energy Regulatory (AER)
GPO Box 3131
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Dear [redacted]

DRAFT WORKING PAPER: TERM OF THE RATE OF RETURN

Endeavour Energy appreciates the opportunity to respond to the AER's draft working paper on its review of the term of the rate of return (term paper). This paper examines the suitable term for setting an efficient rate of return (ROR) and whether the terms for the return on equity, return on debt and expected inflation should align. We note this paper follows the AER's review of the regulatory treatment of inflation where the AER decided to move from a 10 year estimation window to a 5 year one. As part of this review the AER's Consumer Reference Group questioned whether alignment of other estimation terms should be considered.

The key positions and matters discussed in our response can be summarised as follows:

- **Term consistency:** there is no need for consistent term assumptions across inflation, cost of debt and the cost of equity. We support this view as the term should reflect the role of each parameter in the regulatory framework.
- **Cost of debt:** the trailing average cost of debt remains the preferred approach. However, the preliminary AER view is that the term could be changed on the basis of the Energy Infrastructure Credit Spread Index (EICSI) data and corresponding weighted average term to maturity at issuance (WATMI). We support the maintenance of a 10-year trailing average of BBB+ debt on the basis of both the evidence and practical considerations provided herein.
- **Cost of equity:** the case for and against the movement to a 5-year term from a 10 year term is considered with no preliminary view by the AER. We support the continued use of a 10 year term for the risk-free rate in accordance with standard market and regulatory practice.

In our response to the draft working paper we provide this brief response highlighting our key concerns and suggestions. For our more detailed position we refer the AER to the ENA's submission to this review, which we fully endorse.

Overall return that contributes to the long-term interests of customers

The AER notes in the Assessing the long term interests of customers (with respect to the ROR) working paper that[1]:

> *In our view, for the 2022 Instrument to advance the NEO and NGO to the greatest degree, the expected rate of return should be an unbiased estimate of the expected efficient return, consistent with the relevant risks involved in providing regulated network services.*
>
> *If it does, then it will (all else being equal) promote both efficient investment in, and efficient use of, energy network services for the long term interests of consumers.*

We support this view and consider it requires careful consideration of both the individual parameters and the overall ROR estimate itself. We consider the term paper would benefit from a more direct consideration on how the individual preliminary positions in the paper will collectively better advance the National Electricity Objective (NEO) compared to the status quo approach. Our primary concern is that the term paper only considers changes, or flags potential considerations in future working papers, that would -result in further reductions to the allowed return for the sector.

The unprecedented market conditions are producing historically low returns. We do not consider that these current low returns are supporting an efficient level of investment required to lead the energy transition, facilitate the decarbonisation of Australia's economy and maintenance of appropriate levels

[1] AER, Assessing the long term interests of consumers, Position paper, 21 May 2021, p. 12

of system security. This is supported by the Brattle report which found that the AER's allowed return on equity is materially lower than the allowances of other comparable regulators[2]. This remains to be the case following the AER's Victorian Determinations despite the new inflation forecasting methodology being applied.

It is also important for there to be regulatory confidence, stability and predictability as noted by the AER in the financeability working paper[3]:

> *While the FFO to net debt ratio is important, there are a number of other considerations that are equally as important, or are more important. For example, the subfactor 'stability and predictability of regulatory regime' has a 15 per cent weighting in Moody's credit rating methodology.*

We submit that regulatory stability is not promoted by:

- making a material change to the equity term only 3 years after the 2018 RORI was completed with no new compelling evidence of considerations; and
- undertaking a complex and impractical set of nested transitions to change the term of debt by potentially 1 year.

This is not to say the AER cannot make improvements or revise its position in the face of new or additional evidence. We would encourage the AER to do so where the evidence is compelling but with respect to the term of equity and debt we do not consider the threshold for revision has been met.

Hence our concern that the term paper identifies options to further reduce the allowed return, revisit previously settled matters and implement complex but marginal changes. We strongly urge the AER to reconsider how the options and preliminary positions in the term paper will contribute to promoting a stable regulatory environment and deliver an overall allowed return that is efficient given the international comparisons and historically low prevailing returns.

Term of equity

As noted above, the working paper sets out the arguments for and against a movement to a 5 year term for the risk-free rate. This issue has been thoroughly considered in previous ROR reviews and we do not see any compelling reason why it warrants further consideration. It is standard market practice to adopt a 10 year term for the risk-free rate as noted by the AER's experts[4].

> *It is clear that utility investments are typically very long-term investments. This is consistent with the ten-year government bond rate being used as rf (the risk-free rate) in the AER's application of the CAPM. Use of the ten-year government bond rate is standard practice for the measurement of returns appropriate to investment over a long horizon*

All Australian regulators (other than ERA) use a 10 year term and international regulators often use longer rates where available[5]. It should be largely uncontroversial to maintain a 10 year term, a view shared by the AER's experts in the 2018 RORI[6]:

> *Of all the approximations made, assuming that the 10 year government bond rate corresponds to a riskless asset, seems fairly innocuous. This is particularly true when the sovereign debt is highly rated, and inflation is both low and has low volatility.*

Whilst we see no reason to depart from a 10 year term, if there were to be any consideration of an adjustment we are surprised it is not a lengthening of the term that is being considered rather than a shortening. Once again a view we consider to be shared by the AER's own experts[7]:

> *Given the very long term nature of utility assets it is debateable whether 10 years is a sufficiently long horizon, but as a practical matter 10 years is commonly taken as the horizon for estimating the required return of long lived assets including the required return on equity.*

On this point we note that Australian government bonds with a maturity of 30 years have traded for approximately a year. Whilst we do not submit that a 30 year bond be adopted as the proxy for the risk free rate we would suggest that this change has more merit than a 5 year term and that future

[2] The Brattle Group, A Review of International Approaches to Regulated Rates of Return, June 2020, p. 13

[3] AER, Rate of return and cashflows in a low interest rate environment, Draft working paper, 21 May 2021, p. 36

[4] Partington and Satchell, Report to the AER: Discussion of Submissions on the Draft 2018 Guideline, 28 November 2018, p. 30

[5] The Brattle Group, A Review of International Approaches to Regulated Rates of Return, June 2020, p. 39

[6] Partington and Satchell, Report to the AER: Discussion of Submissions on the Draft 2018 Guideline, 28 November 2018, p. 11

[7] Partington and Satchell, Report to the AER: Discussion of Submissions on the Draft 2018 Guideline, 28 November 2018, p. 30

RORI's could consider this further once additional data is available. At this point in time we therefore support the AER's position from the 2018 RORI review which maintained a 10 year term for the risk free rate and the supporting rationale[8]:

> *We consider the appropriate term for the risk free rate should be 10 years because this will lead to an overall return on equity that will better contribute to the achievement of the NEO and NGO. Networks and investors supported this decision. However, the CRG raised concerns that a shorter term of five years was more appropriate. We reached our decision for the following reasons:*
>
> - *The 10 year term is consistent with the theory of the SLCAPM, which is a single period equilibrium model, that estimates the returns an investor requires over a long-term investment horizon.*
> - *The 10 year term is a sufficiently long investment term to serve as a proxy for the long-lived assets under regulation.*
> - *The 10 year term is consistent with actual investor valuation practices and academic works as shown by findings in the KPMG market practitioner surveys, indicating that 85 per cent of practitioners use a 10 year risk free term.*
> - *This is comparable with the investor valuation practices used to value other stocks within the market, with a similar degree of systematic risk*
> - *It is consistent with our estimation of the market risk premium and equity beta*
>
> *We consider a reasonable argument could be made in support of either a five year term or a 10 year term. However, we found support for using a 10 year term in actual investor valuation practices and academic works and consider the evidence for a five year term was less persuasive than that for a 10 year term.*

All of these reasons remain valid with the only new information being Dr Lally's re-framing of the previously rejected arguments which suggest that because investors should require a 5 year return the AER should set the allowance in accordance with this term per the NPV=0 principle. We disagree with Dr Lally's framing of investor expectations and the AER's task.

We agree that the AER's task is to compensate investors for the required return on equity at the time of the decision. This requires the AER to observe how market returns are formed and set an allowance that is reflective of the term that is used. A 5 year risk-free rate is not consistent with NPV=0 where required returns are actually determined in the market on the basis of a 10 year risk-free rate, which the evidence clearly indicates is the case as detailed below.

Dr Lally's argument is that the known end of period RAB represents the expected present value (as at that time) of all future cash flows. This represents the market value of a regulated firm assuming the full recovery of the residual value of the RAB (in cash) at the end of the term is guaranteed. This is clearly violated in practice and implausible in the face of an overwhelming amount of evidence that demonstrates regulated firms are not valued in this way. We support the AER's response to Dr Lally's position on this matter in the 2018 RORI[9] and do not consider there has been any meaningful change in Dr Lally's argument or market evidence that warrants a reevaluation.

Term of debt

The AER's preliminary position for the term of debt is to maintain the trailing average approach but to set the term using the WATMI from the EISCI. Based on its assessment of the most recent 12 months of industry debt data the AER indicates a potential term range of 8 to 11 years. We do not support the AER's preliminary position for a number of evidenced based and practical reasons:

- <u>Industry data supports a 10 year term:</u> the cost of 10 year senior debt issued by networks is in line with the AER's allowance for 10 year BBB+ debt and the cost of debt for all tenors issued by networks is in line with the AER's approach for setting the allowance for BBB+ debt for the same tenor.
- <u>Current outcomes are consistent with incentive regulation:</u> Under an incentive based framework networks are free to depart from regulatory benchmarks and bear the risk and costs of doing so. With respect to debt networks incur the refinancing costs and increased

[8] AER, 2018 Rate of Return Instrument Explanatory Statement, December 2018, p. 88

[9] AER, 2018 Rate of Return Instrument Explanatory Statement, December 2018, p. 130

volatility risk of shorter term borrowing strategies. A departure from the benchmark is the individual choice of a network and not cause alone for a change in benchmark.

- Using actual debt data would distort incentives: Adjusting the benchmark principle potentially shifts risk of debt financing strategies to customers. It is assumed by the AER that the results reveal "outperformance" yet they are in fact consistent with the use of short term bank debt to 'plug' small gaps in financing requirements (which would be expected when transitioning to matching or replicating a trailing 10 year average) or 'catch-up' with longer tenor debt in certain market conditions (such as a financial crises or global pandemic).
- Regulatory stability and predictability is important: many networks explicitly target a 10 year term to align with the regulatory benchmark. A longer term view is required rather than basing critical regulatory decisions on 12 month snapshots of an unrefined dataset. As the AER notes there is a value in regulatory certainty and stability which suggests there should be a high threshold for changes. We are of the view the case for change is absent when the current approach remains fit-for-purpose, is working well and many networks explicitly target a 10 year term to align with the benchmark.
- The EICSI has numerous flaws:
    - Inclusion of NSW data when the NSW networks have been recently fully or partially privatised. These networks are in the process of establishing a portfolio and need time to transition to a steady state. If the EICSI and WATMI is to be relied upon in any substantive manner then the NSW networks should be excluded.
    - The EICSI is not weighted by value or tenor meaning it is materially and disproportionately impacted by short term debt. As aforementioned, short term debt is often a necessary component of a debt portfolio and its skewing of the EICSI is a fundamental and critical flaw that could be addressed quite simply.
    - Exclusion of materially relevant debt costs and subordinated debt despite including the senior debt that the excluded subordinated debt supports.
- The EICSI lacks transparency and reproducibility: the index cannot be replicated, is complex and non-transparent. In particular, the debt data is confidential (which is appropriate) and it is not clear which instruments are included or the weight they receive. Networks and stakeholders will not be able to readily interrogate and derive alternate approaches and it is unclear how an EICSI could operate under a binding RORI where judgment during the annual debt cost update process is not permitted.
- A transition would be complex and impractical
    - A new benchmark would require either a payment to retire debt before maturity or a transition over 10 years. A transition would mean the new debt would have little impact over a single regulatory period as the trailing average of 10 year debt would form the majority of the average.
    - As WATMI changes and moves (which it invariably will) it follows that a new term would be set in the next RORI review. This would necessitate a new transition but networks would only be part way through the 2022 RORI transition, so a third nested transition would be required.

We also note Dr Lally's advice that the assumed efficient debt financing strategy that is used to set the return on debt must be viable in order to satisfy the NPV=0 principle. Given many debt financing approaches would be viable we submit aligning the allowed return on debt with the efficient debt financing practices is the critical task.

On this, a 10 year trailing average was adopted in previous RORI reviews with the support of major energy user[10] and consumer representatives[11] to better match the regulatory allowance to the benchmark efficient costs. Customers have, and will continue to, benefit from the lower volatility in the debt allowance and current low rates under this approach.

[10] Major Energy Users, MEU Response to AEMC Draft Rule Change Amendments, October 2012, p. 13.

[11]Energy Users Rule Change Committee Rule Change Request, supporting report, by CEPA, Estimating the debt margin, October 2011, p. 9.

Given this, and the points raised above, we see no reason to depart from the current approach and consider using the WATMI to set the term of debt would not promote the long term interests of customers.

If you have any queries or wish to discuss our submission further please contact myself on [redacted] or [redacted], Regulatory Strategy Manager at Endeavour Energy on [redacted] or via email at [redacted].

Yours sincerely

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[redacted]
Chief Financial Officer