Global Infrastructure Investor Association

Response to draft decision on the 2022 Rate of Return Instrument and independent panel report

September 2022

1. Background

This response provides a follow-up to our previous detailed submission 'Global Infrastructure Investor Association: Response to AER Final Omnibus Paper' (11 March 2022) contained in Annex A and responds to the 'Draft Rate of Return Instrument' (16 June 2022) and the 'Independent Panel Report'.

2. Current market conditions & their impact on regulatory approaches

2.1. Since our March 2022 submission, the global economic situation has deteriorated significantly, impacting capital market conditions, and placing additional constraints on public and private investors seeking to raise capital to invest.

2.2. In response, GIIA has witnessed regulators and policymakers in many major economies applying more flexible requirements on investors to help maintain and attract high levels of investment to meet national infrastructure objectives – including those examples set out in GIIA's March 2022 submission.

2.3. This open approach has had a largely positive impact on investor sentiment across major markets, as governments and investors work to respond to the volatile economic environment fuelled by inflationary pressures and uncertainty over fiscal and monetary policy.

2.4. There is an increased risk that regulated Australian energy network infrastructure investment will be constrained compared to comparable international regulatory jurisdictions if adjustments aren't made to meet the demands of global market conditions to the ultimate detriment of consumers seeking reliable access to Australian energy services.

3. Meeting the decarbonisation challenge

3.1. Significant public and private sector investment is needed to meet the Commonwealth and State Government's decarbonisation commitments to transition the Australian economy towards a more sustainable grid network, powered by renewable energy.

3.2. Unlocking private capital is key to meeting the decarbonisation challenge. This can be achieved in large part through a stable and transparent regulatory environment that promotes conditions that make large-scale infrastructure investments commercially viable over the long term.

3.3. However, changes such as some of those proposed within the Draft Instrument raise concerns for investors that, in our assessment, will reduce the attractiveness of

investments in Australian energy market infrastructure in comparison to maintaining current arrangements.

3.4. Possible unintended costs include the material impact changes will have on the overall level of investment available in the short to medium term to fund the energy transition through improvements in network transmission, the integration of solar into the grid and the development of renewable gas.

3.5. Any reduction in available capital to fund the pipeline of grid improvements may also impact the ability of the government to reach its 43% NDC target submitted to the UNFCCC by 2030.

4. Term of the risk-free rate

4.1. GIIA members remain very concerned by the proposed term-matching approach outlined in the June 2022 explanatory statement, resulting in a shift to a 5-year risk-free term of equity and overturning a significant pillar of stability in the AER's existing framework.

4.2. The shift in approach raises concerns over the stability and predictability of Australia's rate of return for capital investments in key infrastructure. In previous decisions, critical consideration has been given to expected equity returns to inform assumed required returns on equity. This principle has been applied by other regulators and across many major markets, aligning with investor expectations.

4.3. The 10-year risk free term adopted by most Australian regulators has drawn broad support from private infrastructure investors who require this level of certainty when estimating equity returns on capital invested. The term has also been positively adopted by regulators cognizant of the need to develop a conducive regime to attract investment.

4.4. As cited by the Queensland Competition Authority in its Rate of Return review, they "consider it is reasonable to use long-term Australian Government bonds based on a 10-year term to maturity [because] this approach reflects the requirements of investors and lenders who, in relation to long-lived infrastructure assets, will deploy equity over the *entire life* [emphasis added] of the asset, rather than over any given regulatory period". This view has also been confirmed by the recent draft decision of the WA Economic Regulation Authority to also abandon a previous term-matching approach.

5. Net Present Value (NPV)

5.1. Previous AER decisions have concluded that the NPV=0 principle is consistent with the continued use of a 10-year term of equity. These decisions have also been independent of inflation forecasts, something that the June 2022 Draft Instrument looks to reverse.

5.2. The explanation given to adopt a term-matching proposal does not give weight to the revealed practice of investors and perspectives around efficient equity financing costs.

5.3. The reason given in the explanatory statement for the change in approach is that term matching brings consistency across both areas, with the reasoning supported by in-depth mathematical analysis. However, given the impact of the proposed approach, we believe there is a clear need to address many of the concerns already raised with the efficacy of the approach to ensure all outcomes are fully considered.

5.4. This includes responding to the fact that investors regularly revise their calculation of required returns using a 10-year base risk-free rate, rather than only doing so at 10-year intervals as the explanatory statement suggests[1].

6. Impact of changes

6.1. Divergence from the 10-year baseline period, as proposed by the AER, is expected to have an adverse effect on the attractiveness of the Australian grid network to private infrastructure investors seeking long-term, low risk investments.

6.2. This is due, in part, to the increased level of volatility presented by a shift to a 5-year risk-free rate – unmatched by any other Australian regulator – which has been shown to offer less attractive returns for investors on average[2] while exposing consumers to the risk of higher relative prices during times of economic recession or financial market crises.

6.3. A sufficiently high enough threshold has not been reached in our judgment to justify such a significant change in approach, which is expected to have a negative impact on the attractiveness of the Australian market when considered against similar economies.

7. Independent Panel review

7.1. We note and welcome that the Independent Panel's has recently released its report on the AER's Draft Instrument proposals. The review has brought to light several issues the AER should seek to consider more fully in its final proposal.

7.2. We note that Panel has supported a reconsideration of proposals to attach lower or no weight to the outcomes of other regulatory process, and approaches of other regulators as it conducts its task. As a matter of best regulatory practice GIIA supports infrastructure regulators taking a wider view of the development of international precedents and practice – with a view to testing the robustness of its proposals.

8. Conclusion

8.1. The draft rate of return instrument positively responds to several concerns expressed by GIIA and other stakeholders including the decision to continue to include financeability assessments to inform the rate of return.

[1] AER, Draft Rate of Return Instrument Explanatory Statement, June 2013, p. 15

[2] AER, Draft Rate of Return Instrument Explanatory Statement, June 2013, pp. 95-123

8.2. However, we believe that the concerns expressed by investors to the proposed changes within the Draft Instrument should be given further careful consideration, both in the context of retaining a commercially sustainable framework within regulatory settings and as a means of promoting investment in the energy transition.

8.3. We recommend that the 'term matching' principle upon which the revision to the risk-free rate is based within the June 2022 explanatory statement should be abandoned, with analysis instead needed of similar approaches taken by Australian and international regulators. Our March 2022 evidence outlines several examples of where 'term matching' has been abandoned in favour of the commercial 10-year standard, providing a starting point for analysis.

8.4. GIIA urges the AER to take the likely impact of any changes to the instrument on overall investment levels into account when finalising the instrument, both in the context of market conditions and the competitiveness of the Australian energy market.

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Annex A

Global Infrastructure Investor Association

Response to AER Final Omnibus Paper

Friday 11th March 2022

1. Introduction to GIIA

1.1. Global Infrastructure Investor Association (GIIA) is the membership body for the world's leading investors in infrastructure, and advisors to the sector, who collectively represent over US$1 trillion of infrastructure assets under management across 66 countries. Our members are investing today to provide the smart, sustainable and innovative infrastructure needed for our communities and economies to thrive.

1.2. The investor member base of GIIA is diverse and ranges from fund managers, pension funds, insurers, corporate investors and sovereign wealth funds (a list of GIIA members can be found at giia.net/membership). In Australia, GIIA members are responsible for 23 energy assets with over 2GW of capacity in renewables and 145,000km of transmission grid infrastructure.

1.3. In relation to the AER 'final working paper: overall rate of return, equity and debt omnibus', published December 2021, we are keen to provide the perspective of institutional investors in infrastructure. This response therefore acts as a high-level position statement on behalf of the institutional investor community on the issues raised in the paper and associated 'questions for stakeholders'. By way of background, many of GIIA's members are exposed in various markets across many sectors and not exclusively to the energy market in Australia.

2. The need for investment in Australian Energy Network infrastructure

2.1. GIIA investors operate in a highly mobile global capital market where investment decisions are taken in real-time by investment committees based on the perceived attractiveness of stable and attractive long-term returns on investment. To maintain Australia's attractiveness as a destination for international capital, the AER should seek to ensure, and maintain, internationally competitive rates of return for investors in relevant regulated infrastructure in the Australian Energy Market.

2.2. The AER's 2022 rate of return instrument is also being developed at a time when significant investment in network infrastructure is required to support the energy transition in Australia's energy sector. The Australia Energy Market Operator estimates that 60GW of additional capacity needs to be built over the next 19 years to replace the coal fleet which will require more than A$150bn of investment in energy generation, with grid upgrades also adding to these pressures[1].

[1] Preqin, Power in Australia, the problem and the opportunity (2021), URL

2.3. At the same time, current investment in network infrastructure is close to the lowest point of any time in the previous decade[2]. In this regard, we note that the Australian Energy Market Operator has identified a range of significant interconnection projects, which are foreseen to be required over the next decade. This occurs against a background of a relatively low level of transmission interconnection investment since the commencement of the National Electricity Market.

2.4. This decline in investment has occurred precisely at the same time as the initiation of a sharp downward trend on allowed equity returns by the Australian Energy Regulator, raising questions as to whether the AER's approach on returns to investors has had, or unduly risks, a negative impact on new investment flows.

3. Importance of an internationally competitive rate of return

3.1. It is therefore encouraging to see that the AER has moved in a positive direction in the final working paper published in December and has taken account of some of the views expressed through a number of submissions since the working papers on WACC and Rate of Return Instrument (RoRI), including on equity proposals. However, it remains the case that the AER's current methodology as outlined in the final working paper published in December 2021, is still resulting in outcomes materially lower than those adopted by other comparable regulators around the world which will be a matter of significant concern for both current and potential investors.

3.2. In the UK, the CMA has recently ruled to revise up equity allowances and the weighted-average cost of capital (WACC) from that proposed by the water regulator Ofwat, to a level that will better enable the long term-private investment required in the UK water sector. This should be a matter for significant attention and action for the AER in the preparation of the 2022 final instrument.

3.3. Leading international consultancy Brattle Group, reports that the closest allowance for the real return on equity made by a comparable regulator to that proposed by the AER's methodology, is nearly double the allowance in the AER's most recent decisions[3] and that the AER's allowed nominal return on equity is lower than that adopted by every other regulator for which a reliable comparison could be made [4] (whilst appreciating that the AER is yet to publish the figure for RoE, which will form part of the Draft Instrument in June 2022). Additionally, the AER's allowed real equity risk premium is lower than that adopted by every other regulator for which a comparison could be made[5].

[2] Australian Energy Regulator, State of the Energy Market Report 2021
[3] Brattle reports that Ofwat's real return on equity allowance is 4.19% and Ofgem's allowance is 4.80%. The AER reports that the change in the approach to estimating regulatory inflation in its recent draft decision will increase the real allowed return on equity by 35 basis points to 2.70%, still materially below that allowed by other comparable regulators.
[4] Brattle Group, International Approaches to Regulated Rates of Return (2020), URL
[5] Ibid

4. Term of the risk-free rate

4.1. In addition to the Return on Equity allowance, the other area of concern from the investor community with regards to the AER final working paper is in relation to the proposals on the term of the risk-free rate. The proposed move away from a ten-year to a five-year risk-free rate would not reflect the practices of long-term infrastructure investors in regulated assets. Indeed, previous evidence from the AER, including in its 2018 Rate of Return Review, has found that the ten-year rate better reflects the long-lived nature of energy infrastructure assets and standard commercial practice, thus better supporting the AER's objectives as a regulator of long-term infrastructure investment.

4.2. Some Australian regulators previously adopted a 5-year risk-free rate, but have since determined that a 10-year rate would be more consistent with their regulatory objectives because it better reflects the long-lived nature of the assets and standard commercial practice. For example, the Independent Pricing and Regulatory Tribunal (IPART) changed to a 10-year risk-free rate in its 2013 WACC Review and has adopted a 10-year rate in all subsequent decisions, noting that "…increasing the term-to-maturity from 5 years to 10 years for all industries is more consistent with our objective for setting a WACC that reflects the efficient financing costs of a benchmark entity operating in a competitive market".[6]

4.3. The Queensland Competition Authority (QCA) in its Rate of Return review stated that they "consider it is reasonable to use long-term Australian Government bonds based on a 10-year term to maturity [because] this approach reflects the requirements of investors and lenders who, in relation to long-lived infrastructure assets, will deploy equity over the entire life of the asset, rather than over any given regulatory period".[7]

4.4. The combination of an internationally uncompetitive return on equity allowance alongside a potential move from a ten-year to a five-year risk-free rate will have significant implications for the allocation of capital from private investors in Australian energy infrastructure who will be looking for attractive, stable long-term returns. It is likely to decrease the attractiveness of the Australian energy market as an investible proposition at the very point in time when that investment is required most, in order to support the energy transition across Australia and the recovery to the pandemic.

4.5. So, whilst it is encouraging to see that the AER has moved in a positive direction since the working papers on WACC and Rate of Return Instrument, and specifically in relation to equity allowances, it remains the case that the AER's current methodology as outlined in the final working paper published in December 2021, is still resulting in outcomes lower than those adopted by other comparable regulators and that this is unlikely to deliver the transformational levels of investment needed in Australian energy infrastructure in the years ahead.

5. Unprecedented capital market conditions

[6] IPART, Review of WACC Methodology, Final Report, December 2013, pp. 12-13
[7] QCA, November 2021, Rate of return review: Final report, p. 83.

5.1. It is also important to highlight that the process is being developed during a period of extraordinary conditions in financial markets. Since 2018, financial and capital markets have been displaying a range of conditions, including historically low bond rates and the potential for debt market disruption higher than at any period since 2009. These conditions also emerged well prior to the significant impact of the Covid-19 pandemic on global capital markets which is driving an upsurge in inflationary pressures on economies around the world. Inflation in Australia has risen sharply year on year, 3.5% up from 2021-22. Further capital market uncertainties, and the strong potential for further volatility in investor risk perceptions and other macro-economic parameters also clearly arise in the context of recent developments in Ukraine.

5.2. This raises questions over any approach of the AER to apply a strictly 'business-as-usual' approach to the determination of rate of return, based on decisions taken on the market as it was in 2018 (i.e. before the impact of these conditions in financial markets materialised and before the onset of the Covid-19 pandemic). The instrument needs to be responsive to a wider set of scenarios such as these, to be truly reflective of the market within which investors currently operate in order to support the high levels of investment needed in the Australian energy sector.

5.3. Internationally, other regulatory agencies have responded to similar monetary policy conditions using a variety of approaches. For example, some EU regulatory agencies have made adjustments to rate of return estimates by accounting for the estimated impact of quantitative easing policies. Other regulators, such as Ofgem and Ofwat in the UK, have adopted approaches which are less leveraged to relatively short-term observations of government bond rates, or which do not assume a 1:1 relationship between required equity returns and government bonds. Finally, the UK Competition and Markets Authority has recently adopted approaches in the water sector in their ruling on PR19 price determinations, which evolve traditional approaches to establishing the risk-free proxy measure.

5.4. Should the AER not adjust its approach for these global market conditions, the risk is increased that regulated Australian energy network infrastructure investment will be constrained compared to comparable international regulatory jurisdictions, to the ultimate detriment of consumers seeking reliable access to Australian energy services.

5.5. There are also risks inherent in a regulatory approach that indirectly passes costs for upgrading vital network infrastructure to future consumers and which doesn't prioritise intergenerational equity in the distribution of these costs facilitating later, potentially more expensive costs further down the line.

6. Financeability and cross-check

6.1. Another key finding of the Brattle report 2020, was that other internationally comparable regulators employ a wider range of models and cross checks to inform forward-looking return on equity estimates than that employed by the AER. These financeability assessments and the robust application of cross-checks to help inform discretionary regulatory decisions are important in securing investor confidence in the stability and predictability of a regulatory regime.

6.2. Combining a range of information in a predictable and clear way, against stably applied principles maximises regulatory confidence for all participants. This is in contrast to the application of a single narrowly applied model, or models, which arbitrarily exclude relevant data in the process when establishing a rate of return.

6.3. A range of global regulators adopt financeability assessments as best practice. Some apply it to satisfy particular obligations, while others have simply recognised the benefits to high quality decision-making and better outcomes through the application of these assessments. GIIA encourages the AER to continue to expand and apply financeability assessments as part of its framework for the Rate of Return, Equity and Debt Draft Instrument with a focus on ensuring consistency in the regulatory assumptions which underpin the AER's estimate of return on equity.

7. Summary

7.1. The AER's methodology and approach to the 2022 Rate of Return Instrument, whilst having moved in a positive direction since the WACC and RoRI working papers, still remains out of step with that of any international comparable regulator. GIIA remains concerned that further potential changes to previously consistently adopted approaches to the term of equity risk will exacerbate this state of affairs. The AER is proposing an approach which could have significant negative implications for investment in Australian energy infrastructure, precisely at the moment when this is needed most to deliver the energy transition and support the recovery to the pandemic. GIIA would urge the AER to take this in to account when delivering the Draft Instrument in June, considering the scale of the investment required in Australian energy infrastructure in the years ahead.