IML INVESTORS MUTUAL LTD

Level 24, 25 Bligh Street, SYDNEY NSW 2000
PO Box H104 Australia Square SYDNEY NSW 1215
1300 551 132 Ph +61 2 9232 7500 Fax +61 2 9232 7511

AER consultation on the term of the rate of return

Investors Mutual is an Australian equity fund manager with a long history of investing in the listed utilities and infrastructure space with approximately A$7bn of funds under management. We welcome the opportunity to contribute our views to the 2022 review of the rate of return instrument.

A summary of our positions on key issues are outlined below

- The term for the return on equity should remain at 10 years which is consistent with the long lives of the underlying assets and promote regulatory stability and predictability.
- The term for the return on debt should also reflect the long life of the underlying assets.
- There should be no requirement for the term of debt and equity to match the regulatory period.

A stable regulatory environment is critical

As a long term investor in the regulated utility sector, we value stability, predictability and transparency in a regulatory regime. In assessing equity value, we typically use discounted cash flow (DCF) analysis to discount free cash flow to equity using a cost of equity which is derived from the 10 year Commonwealth Government Bond. This is due to the long lives of the underlying assets being valued and is consistent with a majority of other domestic and international regulatory bodies, some of whom use bond rates of even longer duration.

As far as we're aware, in Australasia, only the ERA and the NZCC use a 5 year bond for the term of the risk free rate. We note that the QCA, which had used a 5 year term, decided to revert to using a 10 year bond as it was *"considered that it would better provide for an overall return that was commensurate with the commercial and regulatory risks involved for regulated entities that invest for the life of the asset (long-term)."*

Australian regulator terms for risk free rate and debt

	Risk free rate term (years)	Debt term (years)
ACCC	10	10
IPART	10	10
QCA	10	10
ESCOSA	10	10
ESCV	10	10
ICRC (ACT)	10	10
ERAWA	5	10
ERAWA (Rail)	10	10

Current investment context is different

Also relevant is the context of the investment environment for regulated assets. The recent historical context is one in which transmission investment was primarily replacement capital spend. AEMO's 2020 Integrated System Plan (ISP) foreshadows the likely need for billions of dollars of additional transmission investment, including distributed energy resource (DER) integration and supporting networks as a platform for services, over the near, medium and long term as Australia transitions away from coal generation. Providing a positive investment signal to deploy capital in large, greenfield transmission projects will be critical in meeting consumer expectations of the future grid to deliver clean, renewable energy and the estimated $11 billion in net market benefits based on AEMO modelling. To meet this objective, an upward bias in the return on equity is warranted, as the alternative is a risk of insufficient investment, potentially leading to poor consumer outcomes.

Financial professionals adopt a longer term view on rates

We have also conducted a survey of financial professionals (equity research analysts) who value assets across the utilities and infrastructure landscape in Australia and New Zealand to gauge how they assess these assets. All of the survey participants use the 10 year bond (or longer in the case of Forsyth Barr) for the term of the risk free rate. The majority appear to use a long term forecast of the 10 year bond rate, or a combination of the spot 10 year rate with historical averaging, likely to account for the fact that current rates are artificially low. The key is that a longer term rate is adopted by virtually everyone surveyed.

Sell side survey of utilities analyst discount rates

	Risk free discount rate	Basis
Morgan Stanley	3.5%	Average of spot 10 year govt bond and 10 year average of the 10 year govt bond
JP Morgan	2.5%	Estimate of long run 10 yr risk free rate
Macquarie Bank	2.6%	Macquarie economist forecast of 10 yr govt bond for first 8 quarters and linear growth to long term 10 yr bond rate forecast over next 32 quarters.
Credit Suisse	1.0%	12 month moving average of the Aus 10 yr govt bond rate
UBS Australia	2.0%	Forecast for the Aus govt 10 yr bond rate
Forsyth Barr (NZ)	2.3%	Estimate of 20 year risk free rate

Survey as at 22/6/2021

In the 2018 rate of return review, the AER maintained the 10 year term for equity and debt. The reasons for that decision equally apply today. The 2022 review suggests a further consideration should be the satisfaction of the NPV = 0 principal whereby consumers should pay no more than necessary for network services. We agree, however this should apply over

the life of the asset and not just a regulatory period. Thus, matching the term of debt and equity with the regulatory period is not required.

In summary, we consider that retaining the 10 year term reflects current regulatory best practice and market practice. If the regulator were to take an alternative approach at this time, this could distort markets as valuation experts take in to account the ‘outlier’ position of the regulator to adopt a shorter term when providing revenue. This is likely to reduce the value of investing in regulated assets, widening the gap between regulated returns and market required returns.

Senior Investment Analyst