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Mr Warwick Anderson
General Manager
Australian Energy Regulator
GPO Box 3131
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By email: RateOfReturn@aer.gov.au

2 September 2022

Dear Warwick

Submission on AER's draft Rate of Return Instrument (RORI)

Jemena welcomes the opportunity to comment on the Australian Energy Regulator's (**AER**'s) draft 2022 Rate of Return Instrument (**2022 RORI**). We appreciate the AER's consultative approach to developing the 2022 RORI.

In this submission, we share our views on the draft 2022 RORI in relation to the following key areas –

- Term of the risk free rate, and
- Market risk premium.

We also support the submissions prepared by the Australia Pipeline and Gas Association (APGA) and Energy Networks Australia (ENA), which our team has contributed to.

We welcome any further queries in relation to this submission. If you wish to discuss this submission, please contact Sandeep Kumar at

Yours sincerely

Ana Dijanosic

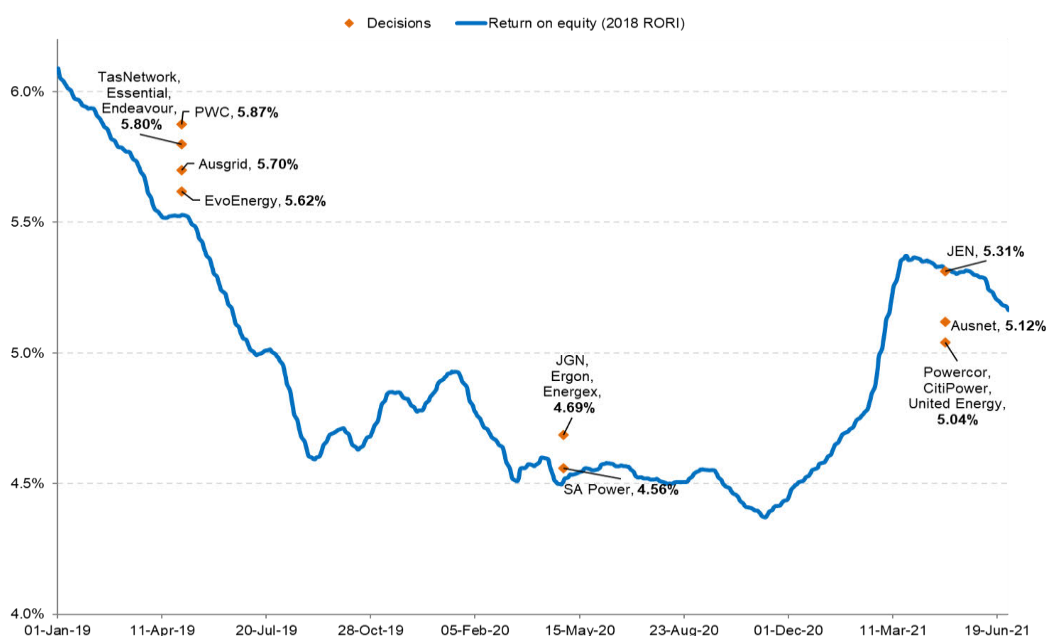
General Manager – Regulation

Annexure A

What we expect from the 2022 RORI

In our experience the 2018 RORI has not delivered efficient returns to investors during the low interest rate environment that existed over the last few years. Jemena, in its September 2021 submission on omnibus papers, provided a chart to demonstrate the low returns and the volatility in outcomes from AER's approach to apply a fixed market risk premium on top of a changing risk free rate (see Figure 1).[1]

Figure 1: AER's return on equity decisions over 2019–21



In Jemena's view, this is the key issue that needs to be addressed in the 2022 RORI to improve stakeholder confidence in the rate of return setting process. Although undercompensating regulated energy networks will have a short-term price benefit to consumers, over the longer term this leads to inefficient investment decisions, which are ultimately detrimental to customers.

The AER's draft 2022 RORI does not address the low returns (in low interest rate environment) or the volatility issue. Rather, the AER's proposal to reduce the term of the risk-free rate actually results in a more volatile risk free rate and return on equity. Not only is the AER proposing to continue estimating the return on equity as a fixed margin over the risk-free rate, it is also proposing to lower the return on equity by adopting a 5 year risk free rate based on assumptions which are neither grounded in finance theory nor in empirical evidence. This can only further dent investor confidence in the AER's ability to set efficient return on equity allowances.

We strongly encourage the AER to rethink its proposal to reduce the term of the risk-free rate and to retain its approach to estimating the return on equity. If the AER does not see issue with estimating

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[1] Jemena, submission on rate of return omnibus papers 3 Sep 2021 (Jemena - Submission - Equity - 3 September 2021.pdf (aer.gov.au)

the return on equity as a fixed margin over the risk-free rate, then we see no case for departing from the approach for measuring rate of return parameters under 2018 RORI at all. There is certainly no case for reducing the term of the risk-free rate.

Risk free rate term

We are concerned that the AER is interpreting its regulatory task in a way that is leading to error. Rather than focus on what returns equity investors require when investing in regulated gas and electricity networks, it is relying on an artificial set of assumptions that effectively mean its regulatory decisions on the length of regulatory period change those requirements.

There is simply no evidence that those assumptions hold in the real world – which means that there is a material risk that it will set an allowed rate of return for a given regulated gas or electricity network that does not provide an opportunity to recover efficient costs. This would undermine the National Gas Objective and National Electricity Objective in fundamental way.

The Australian Competition Tribunal has previously explained that the National Electricity Objective:[2]

> *requires prices to reflect the* ***long run cost of supply*** *and to support efficient investment, providing investors with a return which covers the* ***opportunity cost of capital*** *required to deliver the services.*

Clearly, this requires a view as to what the opportunity cost of capital faced by investors in energy networks. This view was echoed in a recent paper by Professor Schmalensee observes, who observes that:[3]

> *Economic efficiency of course,* ***requires that the allowed rate of return is always commensurate with the return that investors require****…At the most abstract level, the regulatory task is conceptually a simple one –* ***determine the return that market investors require*** *and set each period's allowed rate of return and accounting rate of return to match it.*

In our view, the AER should be seeking to replicate the requirements set by market investors when deciding in which assets to invest their funds. Assuming that investors will adjust their investment horizons in response to the AER's decision on the length of regulatory period makes no sense in such a market, especially given that equity investments have no fixed term (unlike debt investments). It would be remiss of those investors to constrain their return expectations to the length of the regulatory period.

We also concerned that the AER is looking to change the term of the risk-free rate without it being established that change is needed. The explanatory statement for the draft 2022 RORI does not point to a single stakeholder that supports a change to the term of the risk-free rate for the reasons primarily relied on by the AER.

As the explanatory statement illustrates, it is always possible to reinterpret theory. However, doing so makes the AER's decision-making appear arbitrary and creates an unnecessary regulatory risk

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[2] See: *Application by ElectraNet Pty Limited (No 3)* [2008] ACompT 3 at [15]. This quote was endorsed by the Federal Court, including in *Australian Energy Regulator v Australian Competition Tribunal (No 2)* [2016] ACompT 1, 2, 3 and 4 at [77]-[81].

[3] Schmalensee, *Statement of Richard Schmalensee, Ph.D To the Australian Energy Regulator*, 29 July 2022, pp.11–12.

of reinterpreting that theory again in future. Such uncertainty can only ever undermine confidence in the regulatory regime and should be avoided.

Other Australian regulators have previously followed Dr Lally's advice to set the term of the risk-free rate to match the length of the regulatory period. However, they have since changed their positions. For instance, in reverting back to 10-years the Queensland Competition Authority recognised that infrastructure investors "deploy equity over the entire life of the asset, rather than over any given regulatory period".[4]

Similarly, in the explanatory statement to its draft 2022 RORI, the Economic Regulation Authority of WA observed that:[5]

> *the weight of the evidence requires that it change its approach to match **common market practice for long-lived assets and support a longer term market rate** when setting the return on equity.*

We are not saying that the AER should retain a 10-year term for the risk-free rate just because other regulators adopt that term. However, if there is no need for change and no new evidence to support it, then the AER should maintain its current approach.

We support the APGA and ENA submissions, which explore the above concerns further.

Market risk premium

In our view, the AER's proposed approach to estimating the return on equity as a fixed margin above the risk-free rate will lead to a 'lottery' for regulated energy networks and their customers. We have made this point previously:[6]

> *the AER's current approach [that combines a fixed MRP and equity beta with a variable risk-free rate] results in volatile and lottery type outcomes which are inconsistent with delivery of the NEO and NGO objectives of long term economic efficiency.*

We – and other stakeholders – have proposed ways to lower that volatility and reduce the risk that it leads to outcomes inconsistent with the NEO and NGO. The AER does not appear to have properly engaged with those proposals or concerns about volatility.

If the AER is minded to address that volatility which we believe it should, then it should adopt ENA's proposed formulaic approach: whereby the MRP is automatically determined at the same time as the risk-free rate by combining estimates from a calibrated dividend growth model and historical excess returns. The ENA submission provides further detail and support for that approach.

If, however, the AER is not so minded, then it should simply retain its current fixed MRP approach. We believe the decision largely depends on whether the AER considers the MRP to be time varying or not. We understand that during the AER's expert concurrent session, the experts did not reach a unanimous decision on this matter.

We do not agree with the expert panel that the AER should selectively remove periods of high returns when estimating the average historical excess return. Any adjustment to historical series will

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[4] Queensland Competition Authority, *Rate of return review: Final report*, November 2021, p. 83

[5] Economic Regulation Authority, *Explanatory statement for the 2022 draft gas rate of return instrument*, 17 June 2022, p.98.

[6] Jemena, Submission on AER's rate of return information paper, 11 March 2022, p.3.

inadvertently require judgement to be exercised over the entire historical series and result in bias being introduced, making historical estimate of MRP redundant for setting unconditional MRP.