Draft Rate of Return Guideline

A presentation from the Network Shareholders Group –

Spark Infrastructure, Morrison & Co, AMP Capital, IFM Investors, MIRA, AustralianSuper

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Overview

- Who are we?
- What should stakeholders expect from the AER's process?
- What are investors' views on the draft RORG?
- Draft RORG – outcomes and impact
- Implications of the draft RORG
- What should the AER consider for the final RORG?

Who are we?

- We are **responsible custodians** of the retirement savings of millions of Australians via their superannuation funds as well as the capital of hundreds of global institutional investors
- Long term owners and investors investing across market, regulatory and political cycles with a strong fiduciary duty
- We have invested over **$12 billion** in Australian electricity transmission and distribution network businesses
- Key stakeholders in creating a system that **minimises costs** to consumers, **responds effectively** to technology transition, decarbonises and provides **reliability**
- Investment in networks is required to optimise use of existing investment and facilitate entry of new low-cost generation that will reduce costs to consumers

The capital needed to ensure affordable and reliable networks for consumers will be funded by investors like us

What should stakeholders expect from the AER's process?

- End of limited merits review places **great responsibility** on the AER – the end of judicial review significantly heightens that responsibility
- Needs to act in a **fair and balanced** way in the short and long term interests of consumers as well as other market participants - expect **immunity from knee-jerk reactions**
- Expect **recent** decisions to be a strong indicator of current thinking
- Expect **strong evidence** basis for any decisions, with a higher level of evidence in departures from incremental review
- Expect **avoiding unbalanced concessions** towards any group, be they investors, consumers or politicians
- Expect a process that is **genuinely collaborative,** engages and incorporates expert advice and feedback from stakeholders

Investors should be able to rely on recent decisions being relevant and common standards for influence

Outcomes of AER's RORG draft differ from evidence and stated process

- What has the evidence shown?
  - **Historic MRP**: <u>no change or increase</u>
  - **DGM MRP:** <u>increase</u>
  - **Beta:** evidence presented by AER is that it has <u>increased</u>
  - **Tax/Gamma:** data is challenging but credible ATO information suggests a <u>lower gamma</u>. Hard to show anything has changed

- What has the AER done?
  - MRP: reduced (evidence shows increase or no change)
  - Beta: reduced (evidence shows increased)
  - Gamma: increased (evidence show lower gamma)
  - AER says they are not using cross-checks but if using parameter estimates then outcomes should reflect evidence
  - Is the process undertaken that stated at outset by AER?

Investors require transparency, stability and predictability – this has not been delivered

What are investors' views: Accountability, Transparency & Consistency

- On the AER process and parameter outcomes:
  - Expert advice sessions were held but advice largely sidelined as AER adopted only its own advisor comments (selectively), cherry picking expert evidence sessions and agreed positions, disregarding relevant and forward looking information
  - Appear to have accepted the view that the current 'cost of equity' is too high to justify a change in approach. However, there is no evidence to support that this is the case – **erosion of independent, evidence based policy**
  - Significant changes in the scope of the review and current thinking has resulted in the additional scope being excluded from the process to date and a compressed **effective engagement time line**
  - Length of report (nearly 500 pages) has created **opacity and confusion** rather than clarity and justification
- On the objectives and market outcomes:
  - Primacy being given to lower prices in the short term **without regard to the long term interests of consumers** which are aligned with other market participants
  - Disregarded impact on prices, reliability and security over the longer term
  - Disregarded incentives for efficient and sustainable investment

The AER's process is inconsistent with its stated approach and the outcomes ignore agreed expert positions and evidence

Impact on investment confidence

- Erosion of investor confidence is a concern for all stakeholders - investment is needed to provide for a transition to a **cost effective, long term and sustainable** network
- In the IPA Australian Infrastructure Investment Report 2017:
  - Relative to 2016, a decline from 96% to 70% in participants being **highly likely** to invest in Australian infrastructure
  - Also compared to 2016, **energy transmission and distribution fell** as a preferred investment asset type from 55% to 42%
  - 62% report **political risks** as a significant challenge to investing in Australia
  - 74% **agree** that the Australian energy sector is full of uncertainty right now
- From anecdotal evidence around the NSG, the abolition of reviews (merits and judicial), the draft RORG, AER tax review and other interventions have significantly eroded investor confidence

The rate of return has been significantly lowered counter to evidence and increased regulatory and sovereign risk – no confidence

What are investors' views: Stability

- Stability provides a foundation for market participants to deliver least cost for consumers over the medium and long term and reduces volatility in prices for customers
- Instability may deliver short term price benefits to consumers but structurally higher medium and long term prices and price shocks between periods
- NSG supports the stated incremental review approach
- In that spirit of an incremental review we supported the maintenance of the 'foundational model' approach to ROE and accepted the AER's utilisation approach to gamma rather than relitigating issues that have been recently reviewed by the AER, the ACT and the Federal Court

Conclusion – the AER disregarded the need of a high bar for change creating volatility and uncertainty

Implications

- The AER process should deliver well-informed judgements in an impartial, evidence-based manner balancing the interests of all stakeholders to deliver a fair return to investors and fair prices to consumers
- A process for process' sake does not benefit investors or consumers in the long term
- Short term pressures and influences need to be repulsed in favour of a long term regard for the interests of all stakeholders, ultimately underpinning a cost-effective and reliable network
- Results could have far reaching policy and ultimately consumer cost implications
  - Under-investment in the network, leading to market distortion, higher medium and long term prices
  - Reduction of incentives to invest in an environment of increasing sovereign, regulatory risk and propensity for government intervention
  - Inability of the network to become a platform for new technologies, optimise what we already have and support decarbonisation

What should the AER consider for the final RORG?

- How has the process undertaken by the AER been effective in delivering a balanced, appropriate outcome in the long term interests of stakeholders?
- What evidence suggests the rate of return is too high?
- Is this evidence sufficient to support significant changes to the rate of return?
- How does the RORG achieve the NGO, NEO and RPPs?
  - Provide for a fair return on investment
  - Impact on incentives for investment
  - Impact on prices over the medium and long term
  - Impact on services, reliability and security
  - Impact on the energy system

A sense of futility in ongoing contributions – no influence, no recourse