28 November 2022

Mr Warwick Anderson
General Manager, Pricing
Australian Energy Regulator
By email: [redacted]

Dear Mr Anderson,

Re: Invitation for submission on Changing Historical Excess Returns Sample Periods and Australian Commonwealth Treasury Advice ("Advice")

The Network Shareholders Group (**NSG**) comprises a mix of global infrastructure investors with significant and ongoing capital invested in Australian electricity network assets that are subject to the Australian Energy Regulator's (**AER**) Rate of Return Instrument (**RORI**). The RORI underpins significant future investments across the entire energy sector in Australia. An instrument that does not reflect efficient costs will deter capital flows into vital domestic network infrastructure at times when world economies transition to a low carbon environment and jurisdictions compete for efficiently priced private capital.

Approach to advice from Commonwealth Treasury

In our view, underlying principles of good and prudent regulatory practice should inform all AER's decisions on RORI. As outlined in our previous submission, we consider these principles are:

1. The AER's process and approach must be unbiased;
2. Regulatory stability and predictability are essential for encouraging investment;
3. The long-term nature of investment decision making needs to be considered;
4. Market evidence, experience and expertise are relevant to the task;
5. Impacts and outcomes need to be measured; and
6. Transparency of the regulator's decision and process are paramount.

We consider that a late change to the measurement period for Historical Excess Returns (**"HER"**) estimation does not meet the above principles, and therefore support retaining the methodology in the draft RORI.

Investors' response to options for consultation

The issues raised in this consultation relate directly to how actual investors – NSG members included – form market-based expectations. To that end, we provide the following observations based on our experience and direct expertise in these matters:

- **The Treasury Advice does not provide a clear basis for moving away from established AER practice.** The Advice points to a range of uncertainties around the potential impacts of accommodative monetary policies and their subsequent withdrawal. While it indicates that future HER may decline, the level of future equity prices is inherently uncertain and speculative. As Treasury notes, academic and empirical evidence on the impact of the unwinding of highly accommodative monetary policy is limited, mixed, and based largely on observations of a variety of varying policies adopted in different circumstances and countries over time. In our view, this evidence does not result in the 'high bar for change' being met – a threshold which has informed other key design and methodology decisions taken by the AER.

- **Regulatory stability and predictability would be promoted by maintaining an approach consistent with the draft RORI.** Whilst not representing our preferred approach, the method of estimating the Market Risk Premium (**MRP**) with reference to the HER approach is a stable and well-understood element of the AER's framework and practice. Unless there are compelling reasons for change based on a strongly evidenced view that the existing approach will result in a biased and inefficient estimate – which, in our view, the AER has not provided – principles of stability, regulatory confidence and predictability are best served by maintaining the estimation sample and approach consistent with the draft RORI.

  Consumers are the long-term beneficiary of a stable, predictable regulatory framework, which promotes an efficient and sustainable cost of capital and minimises avoidable regulatory risk.

- **Investors do not rely on a highly artificial subset of available return data.** The AER is relying on a HER-derived MRP as a proxy for forward-looking expectations on market returns.

  We are unaware of any real-life investor practice around formation of long-term equity return expectations that support:

  - Removing actual out-turn market returns from 2020 onwards on the basis that monetary policies may have impacted these returns; or
  - Extending measurement periods to capture future restrictive policies that may reverse this impact

  Rather, long-term historical MRP estimates are typically formed based on long-term historical series, encompassing a consistent range of data observations, without arbitrary exclusions or extensions. Moreover, departing from the draft RORI's measurement methodology without robust and evidence-based rationale, creates further uncertainty as to when departures from methodology may be arbitrarily applied in the future.

- **Equity beta estimation periods have not been adjusted, notwithstanding similar market disruption.** Any discretionary exclusion or filtering of market returns data, while calculating beta estimates using full unadjusted data estimates, would effectively be the exact opposite of actual market practice on these market parameters. In the estimation of betas for listed firms, it is relatively common for particularly significant periods of market instability (such as the COVID-19 related trading period around March 2020) to be removed for the purpose of estimation of long-term beta. Regulatory approach must be unbiased and consistent across all RORI parameters. Adopting Treasury Advice on HER without changing beta estimation undermines these basic principles.

Avoidance of perceptions of introduction of additional regulatory risk

We recognise the unusual circumstances giving rise to further consultation on historical sampling periods. In view of the announced deferral of the finalisation of the RORI until February 2023, the AER will effectively make any final methodological decision on sampling with full information around the final estimates.

This highlights the need for the AER to make a decision which is clearly reasoned, transparently principles-based and fully consistent with other reasoning of its final Instrument. Such an approach will reinforce the commitment of the AER to both the reality and, critically, the strong perception of regulatory balance and credibility.

By contrast, a decision at the end of a substantial multi-staged process to depart from regulatory precedent on the basis of limited and equivocal advice, resulting in selection of a known value which is lower than its standard approach, would increase investor perceptions of regulatory risk. This is unnecessary in the circumstances as presented.

Moreover, it will be critical for the AER to signal its firm and consistent commitment to any altered approach into the future. Undue regulatory risk would be generated by an approach which may result in future reviews being undertaken without a clear methodology being committed to over the medium-term, resulting in repeated potential disputes around these issues.

Regards,

[redacted]

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