RARE

13 February 2015

Ms Paula Conboy
Chair
Australian Energy Regulator
Level 35, The Tower
360 Elizabeth Street
Melbourne Central
Melbourne Victoria 3000

Dear Ms Conboy,

The AER recently made proposals for the price controls for regulated energy networks in New South Wales and has invited interest parties to comment on the draft determinations. This letter provides the views of RARE Infrastructure.

RARE is an investor in global listed infrastructure securities with A$11 bn under management on behalf of institutional and retail investors. RARE's approach to investment is to analyse prospective returns over the long-term, and through the application of its research-driven investment process has a good understanding of all the major regulatory regimes used for energy infrastructure.

There are many characteristics of the Australian regulatory framework that makes its energy networks potentially attractive investments. Chief among these is that regulation is independent both in the legal framework and in the way in which it is applied. The AER acts independently to fulfil its mandate, and decisions are subject to challenge.

We also commend the AER for the very detailed work it has undertaken and reported on in making the draft determinations, with a large volume of material supporting its proposals. There has also been a very extensive range of evidence provided by regulated companies and other interested parties as part of the price control review process. In this letter, RARE does not seek to add materially to this, but rather to highlight areas of concern that we have.

The approach to the Rate of Return

First, we are disappointed that the AER continues to adopt a narrow approach to assessing the rate of return. The AEMC, in its rule change decision in 2012, determined that the AER should take account of a broad range of evidence in rate of return decisions. In addition to the Sharpe-Lintner Capital Asset Pricing Model (CAPM), the AEMC required the AER to take account of a range of other evidence, including market evidence. While a limited amount of alternative evidence is discussed, the determinations are overwhelmingly based on the "foundation" model, the Sharpe-Lintner CAPM.

The Sharpe-Lintner CAPM is well-respected. Indeed, RARE uses a version of the CAPM in its own assessments of the returns it requires from investments. However, the CAPM is not slavishly followed, but rather used in conjunction with other market evidence to assess what returns are appropriate for investments in different sectors and geographies.

We appreciate that using alternative evidence other than the CAPM is not easy. The difficulties of this are highlighted in the AER's reports on the rate of return. However, just because it is hard does not mean it should not be done. Ideally it will require interpretation by experienced financial market practitioners to ensure that conclusions drawn are appropriate. We believe that the test of the AER determinations should that the rate of return estimate is appropriate, not that the parameter estimates used in the CAPM methodology are supported by academic evidence. We urge the AER to introduce more flexibility.

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The equity market risk premium used in the Sharpe-Lintner CAPM

In the draft determinations, the AER makes estimates of the premium return required by investors in addition to the risk free rate, known as the equity market risk premium. An assumption that is used by the AER in estimating the required market return is that the equity market risk premium is independent of the risk free rate.

Conditions in financial markets eight years on from the global financial crisis are still remarkable. Around the world risk free rates are at very low levels. Australia is not immune to this, with the RBA reducing cash rates by 25bp last week, and yields on long-term government bonds at historic lows in a range of countries. While this means that the returns from a range of assets are lower than they otherwise would be, it does not follow that the equity market risk premium is unchanged. There is evidence from a range of market commentators (too extensive to present here) that as the risk free rate has fallen in current market conditions, the equity market risk premium has risen. This has not been considered sufficiently in the AER's judgement of the current equity market risk premium.

A practical example of allowed Returns on Equity comes from the United States Electric Utilities, where the average RoE fell from 10.4% in 2007 Rate Cases to 9.9% in 2014 Rate Cases. This relative stability (about 50 basis point movement over seven years) is similar to the stable expectation that financial markets have for equity returns from Australian Energy Networks. In contrast to the lockstep movement of bond yields and allowed RoEs in Australia, the premium to US 10-year bonds has increased from 5.8% on average in 2007 to 7.4% in 2014[1].

The overall package of determinations

As investors we do not simply rely on the rate of return announced by the AER to assess returns, but we also examine a full range of variables and value the resulting cash flows. In this context, the scope for companies to outperform regulatory expectations is important. It is also important for us to appreciate that the approach to estimating allowable costs is fair, appropriate, and not capricious.

It is our understanding that the results of the benchmarking approach used in the draft determinations are rather sensitive to assumptions made. This means that from an external perspective, returns may appear to be determined by a black box model, rather than the skill of management teams. We are concerned that this will introduced a stochastic element in the determination of returns that is rather undesirable.

RARE hopes that the AER will reflect on the issues highlighted above, and ensure that they are considered in making current and future determinations. In RARE's opinion, good investment returns can go hand in hand with good outcomes for customers, and the right approach to regulation by the AER can achieve this.

We would be delighted to meet with you to discuss in more detail if that would be helpful.

Richard Elmslie
Co-Chief Executive Officer
Co-Chief Investment Officer

Jonathan Mirrlees-Black
Head of Research

David Maywald,
Senior Investment Analyst and Portfolio Manager - Yield Strategy

1 Regulatory Research Associates *Major Rate Case Decisions – Calendar 2014*, 15 January 2015