ABN 70 250 995 390
180 Thomas Street, Sydney
PO Box A1000 Sydney South
NSW 1235 Australia
T (02) 9284 3000
F (02) 9284 3456

12 October 2020

[redacted]
General Manager, Networks Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

By email: [redacted]
Cc: [redacted]

Dear [redacted]

Re: AER's Pathway to 2022 Rate of Return Instrument: Draft Return on Equity Working Papers

Thank you for the opportunity to respond to the AER's Draft Working Papers on the estimation of the return on equity. We welcome early engagement on the development of the AER's 2022 Rate of Return Instrument (2022 RoRI) to ensure full consideration of alternative approaches and available evidence.

The 2022 RoRI will significantly impact regulatory allowances over a period where we expect to undertake significant investment to deliver our share of the Major Projects identified by the Australian Energy Market Operator (AEMO) in its Final 2020 Integrated System Plan (ISP)[1] to support the transition of Australia's energy sector.

We expect to spend more than $6.5 billion (Nominal) over the next few years to deliver Project EnergyConnect (PEC), the Queensland to New South Wales Interconnector, the Victoria to New South Wales Interconnector, HumeLink and KerangLink. These Major Projects form part of AEMO's optimal development path and are therefore 'critical to address cost, security and reliability issues' in the NEM.

This is an unprecedented increase in capital expenditure on our network – to put it in context the value of our regulatory asset base (RAB) was $6.4 billion (Nominal) at the start of our current 2018-23 regulatory period. These investments would therefore increase our RAB by more than 100 per cent over the next few years.

In order to attract equity to finance these Major Projects, we must be able to earn a return on equity, which is commensurate with efficient financing costs.

As explained in the Energy Network Association's (ENA) submission[2], the AER's allowed return on equity in its 2018 RoRI is at a record low level in both nominal and real terms. The AER's allowed real return on equity is 2.35 per cent per annum – this is 24 per cent lower than the AER's 2013 Guideline, and the subsequent decline in government bond yields has resulted in a further reduction of 36 per cent. The AER's current allowed return on equity is not commensurate with efficient financing costs.

---

1 AEMO, Final 2020 Integrated System Plan, July 2020 (Final 2020 ISP). Found at Link
2 See section 2.2 and Figure 2 – AER allowed return on equity.

This is recognised by the AER's consultants, the Brattle Group (Brattle), who found that the AER's current allowed return on equity is lower than that adopted by every other comparable regulator operating under broadly similar regulatory regimes. This includes:

> the allowed nominal[3] and real return[4] on equity. Brattle found that the closest allowed real return on equity is almost double the AER's allowance, and

> nominal and real equity risk premium.

Implementing a reasonable approach to the return on equity, that is commensurate with efficient financing costs, is critical to promoting efficient investment in the long-term interests of consumers. In particular, it is necessary to ensure the financeability of Major Projects.

We endorse the ENA's submission on the AER's Draft Working Papers on the estimation of the return on equity, which provides a detailed explanation of the broader issues and solutions in relation to the AER's approach to the estimation of the return on equity, and highlight the following matters:

1. *Accommodate changing market conditions* – As we have seen in relation to the 2018 RoRI, the binding nature of the RoRI can cause problems when financial market conditions change. Since the 2018 RoRI commenced, we have experienced extraordinary changes in market conditions. We consider the 2022 RoRI, must be capable of delivering reasonable estimates of efficient financing costs that are consistent with the National Electricity Objective (NEO) and Revenue and Pricing Principles (RPP) as financial market conditions and circumstances change.
2. *Cross-checks return on equity reasonableness* – Cross-checks are critical to ensure that the allowed return on equity is consistent with the market cost of capital at the time. Cross-checks are commonly used by other regulators to ensure that their estimates reflect changes in financial market conditions. We support the ENA's submission that the AER should identify, through further AER Working Papers, a set of potential cross-checks. We also encourage the AER to consider establishing an independent panel of experienced practitioners to verify these cross-checks.
3. *Financeability tests* – We support the ENA's position that cross-checks should be supplemented by forward-looking financeability tests applying to the RoRI, and the subsequent determination processes, to ensure the benchmark Network Service Provider (NSP):

   > remains financeable in a range of potential financial market conditions, and

   > can access efficiently priced finance to support delivery of customer outcomes.

   This analysis should ensure that the RoRI, when applied to a benchmark NSP, will generate a set of financial metrics that is consistent with the assumptions that underpin the allowed return.

4. *Use of the Sharpe-Lintner capital asset pricing model (SL CAPM)* – We support the continued use of the standard SL CAPM to estimate the allowed return on equity that is required by real-world investors. The SL CAPM is the most commonly used estimation approach by economic regulators and market practitioners globally.

   We consider a clear focus is required to determine how the parameters, which form inputs to the CAPM, are estimated. We strongly support Brattle's recommendations that return on equity parameters:

[3] Brattle, 2020, Table 4, Row 3, p. 49.
[4] Brattle, 2020, Table 4, Row 9, p. 49. 2.42% vs. 4.19%.

- should be forward looking to ensure the expected return on equity is commensurate with prevailing risk and market conditions, and
- reflect the same financial market conditions and therefore should be estimated at the same point in time

5. *Market risk premium (MRP)* – We agree with the AER that the historical excess returns (HER) data has an important role to play in determining the MRP and that the premiums that investors have earned in the past are relevant to the premiums they might require in the future. However, we support Brattle's recommendation that the Dividend Growth Model (DGM) evidence is relevant and can usefully ensure the MRP reflects the prevailing market conditions, which might vary from historical market conditions.

   We endorse the ENA's submission that surveys should not be used when estimating the MRP, given the poor quality of available survey data.

6. *Estimation of equity beta* – We support developing equity beta estimates that are representative of the prevailing risks associated with regulated entities. Brattle shows that the AER's beta is materially below that adopted by all other comparable regulators (even including those regulators who adopt lower gearing than the AER). We:
   - welcome the reports from Brattle and Partington and Satchell, which identify that most regulators use a shorter time frame to estimate equity beta to give greater weight to current financial conditions, and
   - endorse the ENA's submission that beta should be estimated using a range of methods and that international evidence, such as estimates adopted by other comparable regulators, is relevant and should be used to inform the AER's estimate of beta.

7. *Other ENA positions* – we endorse the following other ENA positions:
   - the use of market data in estimating the efficient cost of capital is critical because it provides insights into the actual returns that real-world investors require from undertaking investments. Accordingly, the use of market data is essential to promote outcomes that support the NEO and RPP
   - the implementation of the CAPM can be brought more into line with commercial and other regulatory approaches by having appropriate regard to:
     - a wider range of evidence
     - forward-looking evidence, and
     - international evidence, particularly where the domestic evidence is inadequate.
   - the establishment of a principles-based framework for assessing relevant evidence. This would ensure consistent application of evidence and promote common stakeholder understanding of the meaning and application of each piece of evidence, and
   - the 2022 RoRI should consider the relationship between the MRP and risk-free rate during the term of the 2022 RoRI.

Next steps

We look forward to continuing to work with the AER to address the challenges set out in this letter to arrive at an outcome in the long-term interests of investors and consumers. If you have any questions on this letter, please contact me on [redacted] or [redacted]

Yours sincerely

[redacted]

[redacted]

Head of Regulation