

## Global Infrastructure Investor Association

### AER 2022 Rate of Return Instrument Consultation Response

Thursday 2<sup>nd</sup> September 2021

#### 1. Introduction to GIIA

- 1.1. Global Infrastructure Investor Association (GIIA) is the membership body for the world's leading investors in infrastructure, and advisors to the sector, who collectively represent nearly US\$1 trillion of infrastructure assets under management across 66 countries. Our members are investing today to provide the smart, sustainable and innovative infrastructure needed for our communities and economies to thrive. The investor member base of GIIA is diverse and ranges from fund managers, pension funds, insurers, corporate investors and sovereign wealth funds (a list of GIIA members can be found at [giia.net/membership](http://giia.net/membership)). In Australia, GIIA members are responsible for 23 energy assets with over 2GW of capacity in renewables and 145,000km of transmission grid infrastructure.
- 1.2. In relation to the AER consultation paper 'Rate of Return: Equity Omnibus Draft Working Paper' published July 2021, we are keen to provide the perspective of institutional investors in infrastructure. This letter therefore acts as a high-level position statement on behalf of the institutional investor community on the issues raised in the paper and associated 'questions for stakeholders'. By way of background, many of GIIA's members are exposed in various markets across many sectors and not exclusively to the energy market in Australia.

#### 2. Importance of an internationally competitive rate of return

- 2.1. GIIA investors operate in a highly mobile global capital market where investment decisions are taken in real-time by investment committees based on the perceived attractiveness of stable and attractive long-term returns on investment. To maintain Australia's attractiveness as a destination for international capital, the AER should seek to ensure, and maintain, internationally competitive rates of return for investors in the Australian Energy Market.
- 2.2. The AER's 2018 approach on the Rate of Return Instrument is actually resulting in outcomes lower than those adopted by other comparable regulators, including the CMA in the UK which has recently ruled to revise up equity allowances and the weighted-average cost of capital (WACC) from that proposed by the water regulator Ofwat, to a level that will better enable the long term-private investment required in the UK water sector. This should be a matter for significant attention and action for the AER in the preparation of the 2022 Instrument.
- 2.3. Leading international consultancy Brattle Group, reports that the closest allowance for the real return on equity made by a comparable regulator to that proposed by the AER, is nearly double the allowance in the AER's most recent decisions<sup>1</sup> and that the AER's allowed nominal return on equity is lower than that

---

<sup>1</sup> Brattle reports that Ofwat's real return on equity allowance is 4.19% and Ofgem's allowance is 4.80%. The AER reports that the change in the approach to estimating regulatory inflation in its recent draft decision will increase

adopted by every other regulator for which a reliable comparison could be made<sup>2</sup>. Additionally, the AER's allowed real equity risk premium is lower than that adopted by every other regulator for which a comparison could be made<sup>3</sup>.

2.4. This will have significant implications for the allocation of capital from private investors in Australian energy infrastructure who will be looking for attractive, stable long-term returns. It is likely to decrease the attractiveness of the Australian energy market as an investible proposition at the very point in time when that investment is required most, in order to support the energy transition across Australia.

### **3. The need for investment in Australian Energy Network infrastructure**

3.1. The 2022 RoRI is being developed at a time when significant investment in network infrastructure is required to support the energy transition in Australia's energy sector. The Australia Energy Market Operator estimates that 60GW of additional capacity needs to be built over the next 19 years to replace the coal fleet which will require more than A\$150bn of investment in energy generation, with grid upgrades also adding to these pressures<sup>4</sup>.

3.2. At the same time, current investment in network infrastructure is close to the lowest point of any time in the previous decade<sup>5</sup>. In this regard, we note that the Australian Energy Market Operator has identified a range of significant interconnection projects, which are foreseen to be required over the next decade. This occurs against a background of a relatively low level of transmission interconnection investment since the commencement of the National Electricity Market.

3.3. GIIA accepts that there are a variety of reasons for each network reducing investment and does not suggest that the decline in investment has been directly and solely caused by the reductions in allowed returns that have occurred over the last decade. However, the case remains that the decline in investment has occurred precisely at the same time as the initiation of a sharp downward trend on allowed equity returns, raising questions as to whether the AER's approach on returns to investors has had a negative impact on new investment flows.

3.4. Australia would seem to be out of line with global regulatory practice if it does not recognise this and adjust its approach – particularly given the high level of competition for capital in regulated utility infrastructure likely to be underway over the period of operation of the binding instrument.

### **4. Unprecedented capital market conditions**

4.1. It is also important to highlight that the RoRI process is being developed during a period of extraordinary conditions in financial markets. Since 2018, financial and capital markets have been displaying a range of conditions, including historically low inflation, historically low bond rates, and the potential for debt market disruption higher than at any period since 2009. These conditions also emerged

---

the real allowed return on equity by 35 basis points to 2.70%, still materially below that allowed by other comparable regulators.

<sup>2</sup> Brattle Group, International Approaches to Regulated Rates of Return (2020), [URL](#)

<sup>3</sup> Ibid

<sup>4</sup> Preqin, Power in Australia, the problem and the opportunity (2021), [URL](#)

<sup>5</sup> Australian Energy Regulator, State of the Energy Market Report 2021

well prior to the significant impact of the Covid-19 pandemic on global capital markets.

- 4.2. This raises questions over any approach of the AER to apply a strictly ‘business-as-usual’ approach to the determination of rate of return, based on decisions taken on the market as it was in 2018 (i.e. before the impact of these conditions in financial markets materialised and before the onset of the Covid-19 pandemic). The instrument needs to be responsive to a wider set of scenarios such as these, to be truly reflective of the market within which investors currently operate in order to support the high levels of investment needed in the Australian energy sector.
- 4.3. Internationally, other regulatory agencies have responded to similar conditions using a variety of approaches. For example, some EU regulatory agencies have made adjustments to rate of return estimates by accounting for the estimated impact of quantitative easing policies. Other regulators, such as Ofgem and Ofwat in the UK, have adopted approaches which are less leveraged to relatively short-term observations of government bond rates, or which do not assume a 1:1 relationship between required equity returns and government bonds. Finally, the UK Competition and Markets Authority has recently adopted approaches in the water sector in their ruling on PR19 price determinations, which evolve traditional approaches to establishing the risk-free proxy measure.
- 4.4. Should the AER not adjust its approach for these global market conditions, the risk is increased that regulated Australian energy network infrastructure investment will be constrained compared to comparable international regulatory jurisdictions, to the ultimate detriment of consumers seeking reliable access to Australian energy services.
- 4.5. There are also risks inherent in a regulatory approach that indirectly passes costs for upgrading vital network infrastructure to future consumers and which doesn’t prioritise intergenerational equity in the distribution of these costs facilitating later, potentially more expensive costs further down the line.

## 5. **Financeability and cross-check**

- 5.1. Another key finding of the Brattle report 2020, was that other internationally comparable regulators employ a wider range of models and cross checks to inform forward-looking return on equity estimates than that employed by the AER. These financeability assessments and the robust application of cross-checks to help inform discretionary regulatory decisions are important in securing investor confidence in the stability and predictability of a regulatory regime.
- 5.2. Combining a range of information in a predictable and clear way, against stably applied principles maximises regulatory confidence for all participants. This is in contrast to the application of a single narrowly applied model, or models, which arbitrarily exclude relevant data in the process when establishing a rate of return.
- 5.3. A range of global regulators adopt financeability assessments as best practice. Some apply it to satisfy particular obligations, while others have simply recognised the benefits to high quality decision-making and better outcomes through the application of these assessments. GIIA encourages the AER to continue to expand and apply financeability assessments as part of its RORI framework, with a focus on ensuring consistency in the regulatory assumptions which underpin the AER’s estimate of return on equity.

## 6. Summary

6.1. The AER's approach to the 2022 Rate of Return Instrument seems to be out of step with that of any international comparable regulator. The AER is proposing an approach which could have significant negative implications for investment in Australian energy infrastructure, precisely at the moment when this is needed most to deliver the energy transition and support the recovery to the pandemic. GIIA would urge the AER to take this in to account when setting the 2022 RoRI considering the scale of the investment required in Australian energy infrastructure.

For more information about GIIA and the contents of this submission please contact John Kavanagh, Head of Policy and Public Affairs, GIIA.

jkavanagh@giia.net

[www.giia.net](http://www.giia.net)

+44 (0)20 3440 3920