QRC

submission

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QRC submission to the QCA
the Risk Free Rate and the Market Risk Premium

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ABN 59 050 486 952
Level 13 133 Mary St Brisbane Queensland 4000
T **07 3295 9560** F 07 3295 9570 E info@qrc.org.au

www.qrc.org.au

BACKGROUND

The Queensland Resources Council ("QRC") welcomes the opportunity to comment on the discussion paper, "The Risk Free Rate and the Market Risk Premium", prepared by the Queensland Competition Authority ("the Authority"). We confirm that this submission may be made publically available.

The QRC is the peak representative organisation of the Queensland minerals and energy sector. QRC's membership encompasses exploration, production, and processing companies, energy production and associated service companies. The QRC works on behalf of members to ensure Queensland's resources are developed profitably and competitively, in a socially and environmentally sustainable way.

Rail, port, electricity and water infrastructure is essential for the Queensland resources sector and requires long-term, capital intensive investment. The timely expansion and provision of competitive, reliable and efficient infrastructure is a key to the sector's ability to participate in a highly competitive and cost conscious global market. In Queensland, most of the infrastructure services are provided by regulated entities and the regulated cost of capital is one of the key components in the determination of the pricing of these services.

IMPORTANCE OF THE REVIEW

The QRC welcomes the decision of the Authority to undertake a comprehensive review of its cost of capital methodology for regulated businesses.

We refer to our comments regarding the extreme cost pressures currently being experienced by QRC members as set out in our submission on "Risk and the Form of Regulation". We point out these cost pressures not to suggest that the returns of regulated entities should be artificially reduced in this environment, but rather to highlight the urgency of ensuring that regulated entities are not overcompensated in the assessment of the cost of capital or through other means.

SUMMARY OF THIS SUBMISSION

QRC considers that a consistent approach to calculating the Risk Free Rate and Market Risk Premium should be adopted across regulatory periods, unless there is a clear demonstration that the methodology is not appropriate. Based on our review of the QCA's discussion paper, we see no apparent flaw in the existing methodology, with the exception of the Market Risk Premium, which, based on the Authority's analysis, is "biased upward" and will remain biased upward regardless of changing market conditions.

We understand that certain regulated entities are seeking to change the methodology because the current Risk Free Rate leads to the determination of a cost of equity that is low in historical terms. That is, that current market conditions provide a temporarily unfavourable return on equity (an experience being shared by QRC members). We note that no such adjustment was made when bond yields were at relatively high levels. We note also the QCA's statement that Australian regulators have largely resisted the appeals to seek an uplift to the Risk Free Rate, on the basis that:

(a) current bond yields reflect economic (i.e. demand and supply interaction) conditions in markets and there is no a priori reason to believe that 'low' yields signal a 'problem';

(b) *in terms of compensation, the more relevant consideration is potential 'under-compensation' over the life of the assets - accordingly, some regulatory cycles will result in 'overcompensation' while others will result in 'under-compensation; and*

(c) *when market conditions were previously reversed a number of years ago - and bond yields were near historical highs - regulators did not lower the prevailing risk-free rate or market risk premium at those times, despite appeals from some users and stakeholders to do so.*

We support each of these statements.

THE RISK FREE RATE

QRC supports the current approach adopted by the Authority of:

(a) *using Commonwealth Government bonds as a proxy for the risk-free asset in the CAPM*
(b) *averaging the applicable rate over the 20 trading days immediately preceding the commencement of the regulatory cycle; and*
(c) *setting the term of bond equal to the term of the relevant regulatory cycle.*

→ **The Choice of Proxy**

QRC supports the existing practice of using Commonwealth Government bonds as a proxy for the Risk-Free Rate in the CAPM. We note and support the conclusions of Dr Lally, which appear to dismiss each of the arguments that this is not an appropriate proxy during times of historically low bond yields. We consider the finding that bond yields and the market risk premium are not strongly negatively correlated and that the 'compensation' needs to be accurate over the life of the asset rather than over a regulatory period to be particularly important.

We also note that the views of regulators have largely been that the current 'unusually low' risk free rates are forward looking and reflective of current market conditions. We would add that, given that we are referring to yields on long term bonds, the current yields reflect expectations of <u>long term</u> market conditions. This differs, for example, from a current electricity price or coal price, which reflects supply/demand conditions prevailing in a relatively short period and which indicate nothing about expectations over the term of the regulatory period.

→ **The Averaging Period**

QRC does not have a fixed view regarding the appropriate averaging period, other than that it should be as close as practicable to the commencement of the regulatory cycle, should remain within the 10-40 trading day period generally adopted and that the averaging period should be determined well in advance of the relevant period to avoid manipulation.

→ **The Term of the Proxy**

QRC supports the practice adopted by the Authority in its recent decisions of using a term based on the term of the regulatory cycle. The reasons for this approach were well documented by the Authority in its draft decision on the 2009 QR Network Draft Access Undertaking and in the June 2010 draft decision on QR Network's 2010 Draft Access Undertaking – Tariffs and Schedule F. We note that a number of other regulators in Australia have since adopted this approach and we are not aware of any subsequent information which would indicate a sound basis for changing the approach.

THE MARKET RISK PREMIUM

Assessing the Market Risk Premium is a complex process. As the QRC has not engaged specialist consultants to consider this matter, we rely on the QCA's assessment and limit our comments to specific matters set out in the QCA's discussion paper. While a Market Risk Premium of 6% appears generally consistent with the assessment of Australian regulators, we are concerned that this estimate is derived from an average of four alternatives methods, and that the Authority considers that three of these methods are biased upward.

> **QCA discussion paper: Page 11:**
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> *"the Ibbotson historical average is likely to be biased upward due to the overstated dividend yield series in the pre-1958 data and due to other factors, such as 'survivorship bias'".*
>
> *"the Siegel estimate will also be biased upward, as the Siegel method uses the Ibbotson estimate as its starting point".*
>
> *"the Cornell estimate is unequivocally biased upward as it is an 'upper bound' on the market risk premium. It is an upper bound because the long run growth rate in the aggregate dividends of all firms cannot exceed the growth rate of the economy".*

We do struggle to understand why an estimate derived from four methodologies, three of which are 'biased upward', should be considered a reasonable estimate. To the extent that methodologies are available to correct for this bias, then we suggest that the Authority should perform the appropriate correction.

We particularly query whether the Cornell estimate should be included in the calculation of mean and median values, given that the Authority describes it as "*unequivocally biased upward"* and therefore an *"upper bound"* only. As an upper bound estimate, it should only be used to confirm that other estimates are not too high. If the Cornell estimate is removed from the calculation of mean and median values, the mean estimate becomes 5.44% and the median becomes 5.80%.

THE RISK-FREE RATE, MRP, AND THE GFC

For reasons which are well documented in the Authority's discussion paper and in the work of Dr Lally, we do not consider that a determination of an historically low cost of equity, arising from market outcomes triggered by the GFC, indicates a flaw in the methodology.