Dalrymple Bay Infrastructure

24 August 2021

Charles Millsteed
Chief Executive Officer
Queensland Competition Authority

Dear Mr Millsteed,

Re: Response to the QCA Rate of Return Review draft report

DBI welcomes the opportunity to respond to the QCA's recent Rate of Return Review draft report. DBI considers that the review is timely and that it covers some important elements comprising the rate of return expected by investors to compensate them for investing their capital in businesses the QCA regulates.

The QCA has proposed a range of improvements to the methodology by which it estimates an appropriate rate of return, such as implementing a trailing average cost of debt methodology and using a 10-year risk-free rate. In particular, the QCA's proposed top-down assessment as to whether a submitted WACC value is reasonable is an appropriate recognition of the inherent uncertainties in estimating rates of return. This assessment will also afford the QCA greater discretion in its consideration of matters not typically captured in the CAPM framework, including those relating to the rapidly emerging impact ESG-related concerns are having on the cost of capital for businesses in the coal supply chain.

In response to the QCA's draft report, please find attached a report prepared by HoustonKemp Economists on behalf of DBI, which reflects DBI's position on the relevant matters.

Yours sincerely,

Jonathan Blakey
General Manager – Commercial & Regulation
Dalrymple Bay Infrastructure Limited

Attached: HoustonKemp Economists report - 'ESG considerations and the rate of return'

ESG considerations and the rate of return

A report for Dalrymple Bay Infrastructure

24 August 2021

Report authors

Greg Houston

Brendan Quach

Dale Yeats

Tony Chen

Contact Us

Sydney
Level 40
161 Castlereagh Street
Sydney NSW 2000

Phone: +61 2 8880 4800

Disclaimer

Contents

1. Introduction

We have been asked to prepare this report by Dalrymple Bay Infrastructure Management Pty Limited (DBI) in response to the Queensland Competition Authority's (QCA's) draft report on its rate of return review.

The QCA's draft report proposed a range of improvements to the methodology by which it estimates the rate of return. The specific focus of our report is on how best to account for the effects of environmental, social and governance (ESG) considerations in the estimation of the rate of return.

We also note that in a separate, parallel review the QCA has proposed significant improvements to the methodology by which it estimates forecast inflation.[1]

1.1 The QCA's Draft report

The QCA's draft report on its rate of return review highlighted the relevance of ESG considerations for the rate of return for businesses that operate in the coal supply chain.[2] The QCA observed that:[3]

> In the future, we may also consider risks that entities face, for example, environmental, social and corporate governance considerations — which are becoming more relevant for those industries impacted by climate change policy.

The QCA contemplated various means by which to account for the effects of ESG considerations on the rate of return, these including potential adjustments to the applicable credit rating or equity beta, or broader amendments to the time profile of depreciation.[4]

Although this report is focused on the effect of ESG considerations on the rate of return, we note that the QCA has proposed a range of improvements to the methodology by which it estimates the rate of return, with these including:

- to adopt a cost of debt estimated by reference to a ten-year historical average debt yield; and
- to evaluate the reasonableness of its bottom-up estimate of the WACC – as derived from the individual estimation of each parameter – and to apply an explicit adjustment to that bottom-up estimate if it is not reasonable.

The QCA has also proposed to estimate the market risk premium (MRP) by reference to a single estimation methodology, drawing only on historical data. Although this approach is at odds with the prevailing nature of the MRP and the significant uncertainty surrounding its estimation, the effect of alternative, prevailing estimation methodologies for the MRP could be incorporated through the QCA's proposed 'WACC assessment approach'.[5]

The QCA also highlighted a range of factors that are relevant to the level of systematic risk faced by a business, including its customer base and major expansions.

For example, there may be a significant difference between the level of systematic risk faced by businesses that provide essential services to mass market customers, and those that do not. Similarly, the risks arising

[1] QCA, *Draft position paper Inflation forecasting*, July 2021.

[2] QCA, *Draft report – Rate of return review*, June 2021, pp 33 and 60.

[3] QCA, *Draft report – Rate of return review*, June 2021, p 33.

[4] QCA, *Draft report – Rate of return review*, June 2021, pp 33 and 60.

[5] QCA, *Draft report – Rate of return review*, June 2021, pp 13 to 17.

from major expansions are underlined by real options theory, eg, the Commerce Commission highlighted that:[6]

> Real options theory predicts that firms facing investment decisions that are largely irreversible and subject to significant uncertainty will not invest when the (conventionally calculated) NPV of doing so is zero. This is because when a firm makes such an investment or exercises its option to invest, it extinguishes the opportunity to wait for new information that may influence the desirability of the investment.
>
> …The implication of this is that a firm undertaking an irreversible investment that is subject to uncertainty will require a rate of return that exceeds the conventional cost of capital by a margin that compensates it for the value of delay. That is, it will only invest if it expects to be compensated, over and above its traditional cost of capital, for the loss of this option to defer (Dixit and Pindyck, 1994, Chapter 1).

In our opinion, the estimation of equity beta should be guided by a forward-looking assessment of the factors that are most pertinent to the *long term* systematic risk of a business. This long term perspective reflects that investors evaluate risk over the life of an investment.

For example, the QCA's assessment of contractual arrangements should be focused on whether those agreements are effective at mitigating *long term* systematic risk, rather than only smoothing returns in the short term.

The QCA also invited submissions on the level of debt raising costs incurred by businesses. We explain the effect of ESG on DBI's debt raising costs in Appendix A1.

1.2 Structure of this report

The remainder of our report is structured as follows:

- in section two we briefly describe how the integration of ESG considerations in investment decision-making is permeating all levels of the financial system, with significant consequences for the availability and cost of capital for certain businesses; and
- in section three we discuss potential means by which to account for the effects of ESG considerations in the estimation of the rate of return.

In Appendix A1, we summarise strictly confidential information provided to us by DBI in relation to its experience of ESG considerations.

[6] Commerce *Commission, Revised Draft Guidelines – The Commerce Commission's approach to estimating the cost of capital*, 19 June 2019, pp 55-56. Reference to Dixit, A and Pindyck, R, *Investment under uncertainty*, Princeton: Princeton, New Jersey, 1994.

2. ESG considerations

The societal imperative for economic activity across-the-board to mitigate the risks associated with climate change is having profound consequences for investors' capital allocation decisions, and so the availability and cost of capital for firms that are perceived to be particularly exposed to the risks associated with societal responses to climate change.

Consideration of climate-related risks by the investment community falls under the banner of ESG considerations. The integration of ESG considerations into investment decision-making is permeating all levels of the financial system, from the policy landscape to decisions by major investment institutions and credit ratings agencies.

Although this process has been under way for some time, the growing societal focus on ESG considerations – and the implications of climate-related risks in particular – is now emerging as a significant force for change in financial markets.

We describe below the growing recognition of ESG considerations among policymakers and financial sector institutions.

2.1 Policy landscape

One of the earliest policy initiatives in relation to ESG considerations was the 2005 establishment of 'principles for responsible investment', now known as PRI, which were developed by international institutional investors in a process convened by the Secretary-General of the United Nations.[7]

The PRI comprise six principles directed at bringing investment and social objectives into alignment, with signatories to the PRI managing $US103.4 trillion of assets in 2020.[8]

Since then, ESG considerations have been the subject of a range of international financial policy initiatives. We briefly canvas some of the key policy initiatives below.

In December 2015, 196 parties signed the Paris Agreement, which aims to strengthen the global response to the threat of climate change by:[9]

> Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.

In 2016, The European Commission established the High-Level Expert Group (HLEG) on sustainable finance to establish a roadmap towards a sustainable financial system that fosters sustainability in economic, social and environmental developments.[10] The HLEG provided a series of recommendations to the European Commission and explained that:[11]

> **…sustainable finance is about two imperatives.** The first is to improve the contribution of finance to sustainable and inclusive growth as well as the mitigation of climate change. The second is to strengthen financial stability by incorporating environmental, social and governance (ESG) factors into investment decision-making. Both imperatives are pressing, given the rising climate-

[7] PRI, *Principles for responsible investment – An investor initiative in partnership with UNEP finance initiative and the UN global compact,* 2020, p 6.

[8] PRI data are available at https://www.unpri.org/pri/about-the-pri.

[9] United Nations, *Paris Agreement*, 2015, article 2.1(c).

[10] HLEG on sustainable finance, *Financing a sustainable European economy – Interim report,* July 2017, p 9.

[11] HLEG on sustainable finance, *Financing a sustainable European economy – Final report,* 2018, pp 6 and 13.

> related risks and degradation in the environment and other sustainability areas. [emphasis in original]

Further, China is in the process of establishing a green financial system, which the People's Bank of China has explained will promote economic activity that supports the environment, the mitigation of climate change and the efficient use of resources.[12]

Standard and Poor's (S&P) has highlighted that the achievement of China's commitment to achieve carbon neutrality by 2060, as announced in 2020, will have important consequences for the steel industry, which uses metallurgical coal as a production input and is one of the three largest producers of carbon dioxide in China, ie:[13]

> As China commits to a carbon-neutral future by 2060, the country's steel industry will play an important role in reducing emissions by upgrading facilities, increasing the usage of steel scrap in steelmaking and adopting hydrogen-based technology, according to industry experts.

2.2 Financial institutions

The effects of ESG considerations on the investment decisions of major financial institutions and their customers are underlined by the stance of three major institutions involved in the global capital allocation process, being BlackRock, Vanguard and State Street Global Advisors. Collectively, these institutions:

- received more than 80 per cent of all assets that flowed into investment funds over the past decade;[14]
- own the highest share in 438 of the 500 companies that comprise the S&P500 index, which account for approximately 82 per cent of the S&P 500 market capitalisation;[15] and
- represented an average of approximately 25 per cent of the shares voted in director elections at S&P 500 companies in 2018.[16]

2.2.1 Blackrock

The principal focus of the Chief Executive Officer (CEO) of BlackRock's separate letters to its clients and to corporate CEOs in both 2020 and 2021 related to ESG considerations, as highlighted in the report we prepared in response to the QCA's discussion paper.[17]

Blackrock has also explained that it is:[18]

> …making sustainability integral to the way BlackRock manages risk, constructs portfolios, designs products, and engages with companies. We believe that sustainability should be our new standard for investing.

[12] People's Bank of China, *The People's Bank of China and six other agencies jointly issue "Guidelines for establishing the green financial system",* available at http://www.pbc.gov.cn/english/130721/3131759/index.html, accessed 18 April 2021.

[13] S&P, *Steel sector is key to reducing China's carbon emissions*, 8 December 2020, available at https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/steel-sector-is-key-to-reducing-china-s-carbon-emissions-61634240, accessed 5 May 2021.

[14] Bebchuk, L and Hirst, S, *The specter of the giant three*, Boston University Law Review, volume 99, 2019, p 723.

[15] Fichtner, J, Heemskerk, E M and Garcia-Bernardo, J, *Hidden power of the big three? Passive index funds, re-concentration of corporate ownership, and new financial risk,* Business and Politics, volume 19, 2017, p 313.

[16] Bebchuk, L and Hirst, S, *The specter of the giant three,* Boston University Law Review, volume 99, 2019, p 724.

[17] HoustonKemp, QCA's rate of return review, 28 January 2021, pp 22-23.

[18] BlackRock, *Sustainability as BlackRock's new standard for investing – Letter to clients*, available at https://www.blackrock.com/au/individual/blackrock-client-letter, accessed 17 April 2021.

In addition to incorporating climate considerations in its capital market assumptions, Blackrock will:[19]

- offer versions of its flagship model portfolios that use ESG-optimised index exposures instead of the traditional market capitalisation weighted index-exposures;
- require portfolio managers to manage exposure to ESG risks and to document the effect of those considerations on their decisions;
- remove from its portfolios companies that generate more than 25 per cent of revenue from thermal coal and closely scrutinise businesses that are reliant on thermal coal;
- stress-test issuers and its portfolios under various carbon pricing scenarios and enable customers to screen for ESG risks, including in relation to fossil fuels;
- publish information on the sustainable characteristics of its funds; and
- double its offerings of ESG exchange traded funds (ETFs) over the next few years.

2.2.2 State Street Global Advisors

Consistent with the catalyst for BlackRock's integration of ESG considerations, State Street Global Advisors (SSGA) has incorporated ESG into its investment practices because:[20]

> Investors are increasingly demanding ESG strategies and guidance, and we have answered their call by developing a suite of products and solutions that integrate ESG data into our clients' portfolios.

The practical integration of ESG considerations by SSGA is through:[21]

- asset stewardship, ie, using its ownership status through proxy voting and engagement with companies on ESG issues that impact long term value;
- customised advisory services, which are designed to assist clients in effectively constructing resilient portfolios and risk management;
- its proprietary ESG scoring system, Responsible Factor or R-Factor, which covers more than 5,000 companies and measures the performance of a company's business operations and governance as they pertain to financially material ESG issues faced by the relevant industry;[22]
- expanding its investment solutions to provide greater access to ESG products; and
- providing thematic investing around climate solutions.

2.2.3 Vanguard

Vanguard has explained that ESG investing will be an enduring feature of the investment landscape because:[23]

- investors are seeking investments that align with their values, in addition to generating financial returns;
- recent studies show that ESG issues have neutral to positive impacts on company performance, while integrating these factors can facilitate earning a competitive rate of return; and
- improvements in transparency and the standardisation of ESG data and reporting has increased the take up of ESG products by institutional investors.

[19] BlackRock, *Sustainability as BlackRock's new standard for investing – Letter to clients*, available at https://www.blackrock.com/au/individual/blackrock-client-letter, accessed 17 April 2021.

[20] State Street, *Corporate responsibility report,* 2019, p 26.

[21] State Street, *Corporate responsibility report,* 2019, p 26.

[22] State Street, *Corporate responsibility report,* 2019, p 30.

[23] Vanguard, *ESG investing – Investing based on the issues that matter to you,* 2018, p 5.

Vanguard integrates ESG in its decisions by means of a three-part framework, which comprises:[24]

- investment management practices, along similar lines to Blackrock;
- investment stewardship, ie, working to ensure that the actions and operations of public companies create long term value for fund shareholders, eg, through voting proxies at company shareholder meetings; and
- corporate stewardship, ie, seeking to create long term value for stakeholders through business strategy and sustainable operations.

2.2.4 Summary

The strength of the developments we briefly highlight above is marked by the strong reallocation of capital towards ETFs that track the returns of businesses that operate consistent with ESG considerations, as well as by the persistence of that reallocation throughout the COVID-19 pandemic. For example, the Australian Financial Review recently highlighted that:[25]

> When COVID-19 erupted, climate change investing was meant to take a back seat. The opposite happened: money poured into funds that invest sustainably…
>
> In Australia, money flowed into funds with rigorous environmental, social and governance (ESG) screening.

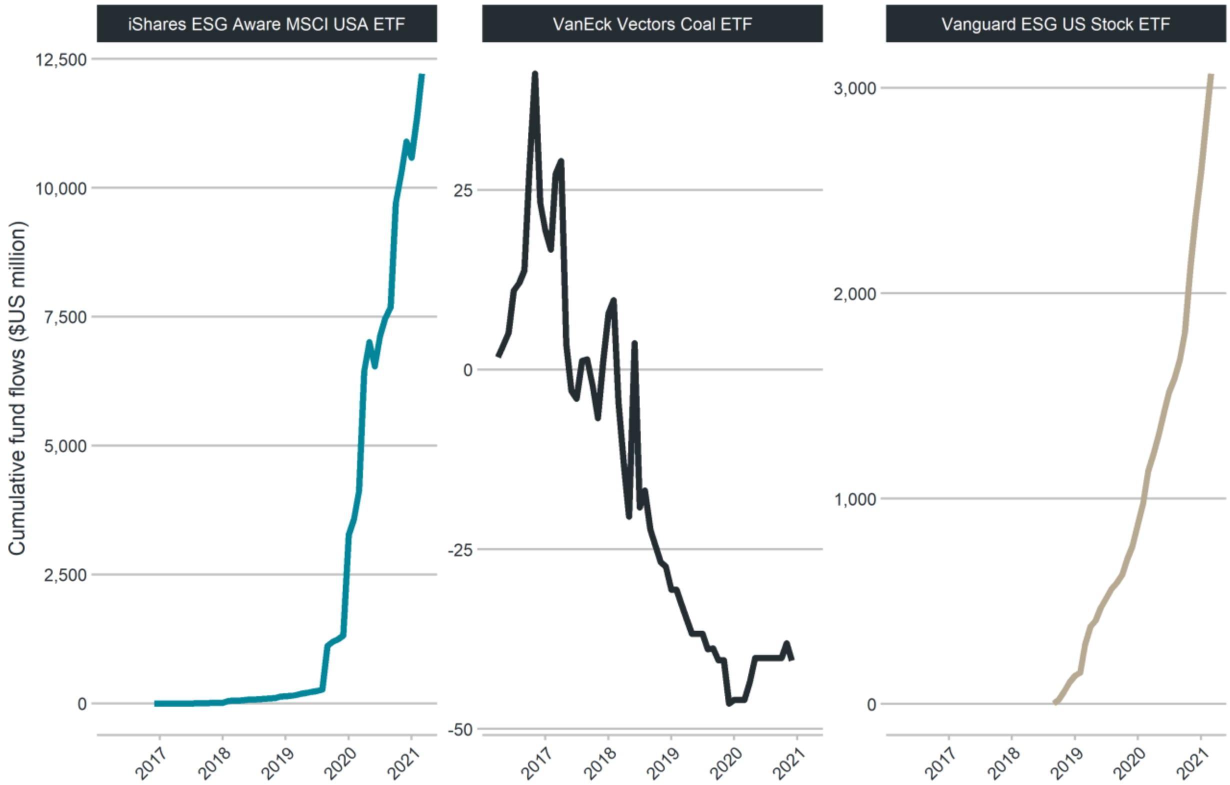
We illustrate this reallocation of capital in Figure 2.1 by reference to the rapid growth in funds invested in two major ESG ETFs, and out of the only coal ETF we have been able to identify, which has since closed.[26]

[24] Vanguard, *ESG investing – Investing based on the issues that matter to you,* 2018, pp 6-7.

[25] Australian Financial Review, *Climate change investing: jolly green giant or next bubble?,* 20 March 2021, available at: https://www.afr.com/wealth/investing/climate-change-investing-jolly-green-giant-or-next-bubble-20210316-p57ba3, accessed 17 April 2021.

[26] Barron's, *The only coal ETF is closing. What it means for investors,* 17 December 2020, available at: https://www.barrons.com/articles/the-only-coal-etf-is-closing-what-it-means-for-investors-51608225200, accessed 17 April 2021.

Figure 2.1: Cumulative fund flows for select ESG and coal ETFs



Source: HoustonKemp analysis of Bloomberg data. Fund flows reflect the net of all cash inflows and outflows.

2.3 Debt markets

The effects of ESG considerations in the finance sector emerged first in equity markets. However, ESG considerations are increasingly having consequences in debt markets. FitchRatings (Fitch) recently noted that:[27]

> While the initial focus was on equities, the much bigger fixed income universe has taken an increased interest in ESG investing across all asset classes…

Fitch Ratings (Fitch), Moody's Investor Services (Moody's) and S&P Global Ratings (S&P) all incorporate ESG considerations into their credit rating decisions, in some form or other.[28]

Fitch explained that:[29]

> Due to client demand and the large number of studies showing links between ESG factors and investing and financial performance, investor awareness and understanding of the financial benefits of ESG investing has grown tremendously.

[27] Fitch Ratings, *ESG in credit 2020 – White paper,* 2020; Moody's Investor Service, *Moody's approach to assessing ESG in credit analysis,* 25 October 2017; and S&P, *ESG in credit ratings – Overview,* available at https://www.spglobal.com/ratings/en/products-benefits/products/esg-in-credit-ratings.

[28] See: Fitch Ratings, *ESG in credit 2020 – White paper,* 2020, p 6;

[29] Fitch Ratings, *ESG in credit 2020 – White paper,* 2020, p 6.

Further, each of Australia's major banks – Westpac, Commonwealth Bank of Australia, ANZ and NAB – have publicly supported the goals of the Paris Agreement and the transition to a low carbon economy.

The primary role of banks with respect to the Paris Agreement is to facilitate financial flows that are consistent with a pathway towards low greenhouse gas emissions and climate-resilient development. Each of these major Australian banks has therefore instituted policies regarding their lending practices to the coal sector.[30]

2.3.1 Joint Standing Committee on Trade and Investment Growth

The consequences of the policies discussed above were noted by a range of coal-related businesses and industry bodies in testimony and submissions to the Joint Standing Committee on Trade and Investment Growth.

The Chief Executive Officer (CEO) of Whitehaven Coal, Paul Flynn, highlighted that:[31]

> …back in 2014, we had all Australian banks being members of our banking syndicate, inclusive of a range of foreign banks as well. It's a matter of public record that we no longer have, in our lending facility, CBA and ANZ. So there's definitely been a contraction over time.
>
> …In the case of our relationship with CBA, that was a retreat from the facility altogether. In the case of ANZ, it was a decline over time and, more recently, removal from the corporate facility that Whitehaven had enjoyed strong international support for.

The CEO of Whitehaven Coal also highlighted that decisions by domestic banks not to participate in debt issuances had flow-on effects with international banks, ie, he explained that:[32]

> …international banks look, very clearly, to the leadership of the Australian national banks in providing detailed assessment of the banking proposition when they come in to join our syndicate. So the national banks are very influential, and in fact we have had direct feedback from international banks that they would struggle to participate where the Australian banks, the Aussie banks, are not participating.

The theme of this testimony was underlined by a range of submissions to the Joint Standing Committee on Trade and Investment Growth.

For example, Yancoal highlighted that:[33]

> In terms of raising capital, the policies of domestic lenders have both direct and consequential impacts to our continued operations. A growing percentage of Australia's major lenders, faced with sustained activism, are declining to be a party to new coal operations. Many are also looking at imminent strategies to exit their existing business involving the production of coal.
>
> This reduced lending pool in turn will drive up the cost of obtaining financial services from those remain in the market.

[30] See: Westpac, *Climate change – Position statement and 2023 action plan,* p 6; Commonwealth Bank of Australia, *Annual report 2020*, p 43; ANZ, *Climate-related financial disclosures,* 2020, p 1; and NAB, *ESB risk management,* available at: https://www.nab.com.au/about-us/social-impact/shareholders/esg-risk-management, accessed 7 April 2021.

[31] Joint Standing Committee on Trade and Investment Growth, Transcript – *Prudential regulation of investment in Australia's export industries*, 25 June 2021, p 2.

[32] Joint Standing Committee on Trade and Investment Growth, Transcript – *Prudential regulation of investment in Australia's export industries*, 25 June 2021, p 3.

[33] Yancoal, *Submission to the inquiry to the prudential regulation of investment in Australia's export industries*, pp 2 to 3.

The Queensland Resource Council (QRC) similarly highlighted global changes in how the financial sector is appraising and managing climate-related considerations, and that:

> …the rapid implementation of these changes is yielding unintended consequences and has reached a critical point which is now affecting the financial viability of Queensland's export industries.[34]
>
> ...The banks do not appear to differentiate between companies who own or operate mines, and the extended supply chains that play a role in servicing these operations.[35]

The QRC also highlighted that the practice of 'virtually all banks based in Australia' reflected comments by ANZ Banking Group's head of institutional banking, Mark Whelan, that:[36]

> …the pressure for decarbonisation of its loan portfolio had increased significantly over the past 18 months and much of that pressure came from regulators in 34 different countries.

Adani Australia similarly observed that:[37]

> While the senior executives of the major banks may talk about transitioning the thermal coal industry, it is our observation there is little evidence of transitioning occurring; if anything, bank officials are displaying a zealot like enthusiasm to withdraw from the industry.

In addition to the effects of ESG on the availability and cost of capital, each of the above parties, and many others, highlighted the significant effects of ESG on the availability and cost of insurance.

DBI's experience of ESG is summarised in appendix A.1.

2.4 Summary

The discussion in this section highlights the rapid integration of ESG considerations in investment decision-making across all levels of the financial system. Further, the effects of ESG considerations on the availability and cost of capital for businesses have increased markedly in recent years and it would be reasonable to expect this trajectory to continue in future years.

It is also apparent that, although the integration of ESG considerations in investment decisions first emerged in relation to equity markets, the permeation of similar considerations is now well under way in debt markets.

[34] Queensland Resources Council, Submission – *inquiry to the prudential regulation of investment in Australia's export industries, 30 April 2021*, p 3.

[35] Queensland Resources Council, Submission – *inquiry to the prudential regulation of investment in Australia's export industries, 30 April 2021*, p 11.

[36] See: Joint Standing Committee on Trade and Investment Growth, Transcript – *Prudential regulation of investment in Australia's export industries*, 25 June 2021, p 24; Queensland Resources Council, Submission – *inquiry to the prudential regulation of investment in Australia's export industries, 30 April 2021*, p 4; and Australian Financial Review, *Why AGL is wise to cut coal free*, 30 March 2021.

[37] Adani Australia, *Submission to the Joint Standing Committee on Trade and Investment Growth Inquiry into the Prudential Regulation of Investment in Australia's Export Industries*, April 2021, p 9.

3. Incorporation of ESG considerations

In this section we discuss potential means by which to account for the effects of ESG considerations in the estimation of the rate of return.

In assessing the various elements of the usual framework for distinguishing and compensating for the financial risks associated with an investment, it is helpful to distinguish:

- the risk and so consequences of climate-change related developments that are likely to occur in the real economy and so for the operations of particular firms that are more highly exposed to relevant sectors of the economy, such as:
  - the prospect that a particular industry may face a more rapid decline in demand for its output, and so an increased risk of stranded assets; and
  - the prospect that the systematic risk characteristics of a particular industry may change, by consequence of its financial risks being more (or less) correlated with wider investment markets; and
- the consequences of a reduction in the availability of investment capital that is willing to be deployed to industries or sectors that are regarded as blighted in relation to ESG considerations, irrespective of the extent of specific or systematic risk associated with the industry or sector.

In our opinion, the first of these risk categories – being the systematic and specific risks distinguished within the capital asset pricing model (CAPM) framework – are more readily incorporated within the established framework for estimating the appropriate rate of return, while the second risk category is not.

3.1 Adjustment to the overall rate of return

The growing integration of ESG considerations in investment decision-making has profound consequences for the availability and cost of capital for businesses that are perceived to score poorly when assessed against ESG criteria, particularly in relation to environmental considerations.

This fundamental reshaping of investment decisions by reference to considerations that sit outside long-accepted, financial drivers of risk and returns cannot readily be incorporated into conventional frameworks for the estimation of the rate of return.

For instance, the availability and cost of debt capital for two businesses with an identical credit rating and very similar financial characteristics can be markedly different if one is perceived to score more poorly against ESG criteria. Similarly, perceptions as to ESG considerations can lead to significant differences between the availability and cost of capital for businesses that face the same level of systematic risk.

In our opinion, it is therefore not sufficient to account for the effects of ESG considerations on the cost of capital through adjustments to conventional measures of financial risk, such as a firm's credit rating or equity beta.

Although investors' recognition of ESG can lead to additional investment risks[38] and these challenges are sometimes referred to under the banner of 'ESG risk', this categorisation overlooks the inherent nature of ESG considerations, as being unrelated to the financial characteristics that have been long-accepted as determinants of risk and required returns.

In our opinion, the effect of ESG considerations on the rate of return is most clearly viewed through the prism of supply and demand, whereby the cost of capital for businesses that are perceived to score poorly against

[38] For instance, a business that is perceived to score poorly against ESG criteria may face heightened refinancing risk due to a reduction in the pool of willing investors.

ESG criteria is driven upwards by means of a consequent reduction in the pool (or supply) of willing investors.

Consideration of these factors lends strong support to accounting for the effect of ESG considerations on the rate of return by application of an overall, top-line adjustment to the rate of return, rather than by application of various adjustments to the components of the weighted average cost of capital (WACC) estimation framework.

It follows that the QCA's proposed 'WACC assessment approach' is a prime candidate means by which to account for the effect of ESG considerations on the rate of return.

3.2 Empirical analyses

The recent and rapid emergence of ESG considerations as a fundamental driver of investment decision-making presents a significant challenge for empirical assessment of the effect on the rate of return.

The relatively short period of time since ESG considerations gained traction in financial markets means there is relatively limited empirical data by which to assess its effects on rates of return. Further, there is no reason to expect that the trajectory of this force for change will abate in the future, with the consequence that the available empirical data is likely to underestimate its effect in the future, particularly over a five year regulatory period.

Nevertheless, empirical assessments that could shed light on the effect of ESG considerations on the rate of return include:

- assessments of the difference between the cost of debt for businesses with a similar credit rating, but that are perceived to score differently against ESG criteria; and
- the application of dividend growth models to evaluate the existence of a premium on the returns of businesses that face a similar level of systematic risk, but that are perceived to score differently when assessed against ESG criteria.

We concur with the QCA's recognition and consideration of these emerging issues and look forward to contributing further to the incorporation of ESG considerations in the estimation of the rate of return.

A1. Appendix – DBI's experience of ESG (strictly confidential)

Sydney
Level 40
161 Castlereagh Street
Sydney NSW 2000

Phone: +61 2 8880 4800