Consumer Reference Group

SUBMISSION TO AER RATE OF RETURN REVIEW: DEBT DATA WORKING PAPER

14 AUGUST 2020

Executive summary

The Consumer Reference Group (CRG) for the Australian Energy Regulator's (AER) Inflation Review 2020 and Rate of Return Instrument 2022 was appointed by the AER in June 2020. The CRG's role is to represent consumer perspectives and interests in these two reviews.

In June 2020, the AER published a draft working paper[1] on energy network debt ("the working paper"). The working paper presents the results of AER work in association with consulting firm Chairmont to develop an index of actual energy network debt costs termed the Energy Infrastructure Credit Spread Index (EICSI). The index builds on earlier work performed by Chairmont for the previous Rate of Return Instrument.

The working paper seeks stakeholder views on the ways the AER can best make use of the EICSI in determining the cost of debt component of the Rate of Return Instrument.

In the limited time since being appointed, the CRG has begun to consider how to best gather and evaluate evidence of consumers' views relevant to the AER's Rate of Return Instrument Review. In this context, the CRG has been careful to frame its analysis to focus on consumer impacts and long-term interests of consumers. The CRG is establishing a working definition of "energy consumers" that recognises they are a diverse group with a wide range of energy needs, expectations and preferences. The CRG has also undertaken initial engagement activities involving semi-structured interviews with consumer advocates to help inform this submission. Importantly, the CRG acknowledges its engagement activities have been limited to consumer advocates, due to the timing of the submission and available resources. Nevertheless these early insights highlight valuable consumer-oriented perspectives as well as the challenges in translating the complexities of a highly technical review topic into meaningful consumer engagement.

Acknowledging the time limitations, the CRG considers that the potential use of EICSI as a substantive input into determining the cost of debt component of the rate of return entails a trade-off between multiple principles. While, the EICSI appears to have the potential to reduce efficient costs for energy consumers, depending on how the AER uses it, it does not perform as well against other principles to evaluate the effectiveness of the regulatory model.

Our initial engagement with consumer advocates has indicated that cost continues to be a major concern for many energy consumers. Reforms to the Rate of Return Instrument that help reduce customer bills by better reflecting the actual costs of raising debt experienced by network businesses are welcome.

Our initial view is that the EICSI performs well in terms of efficiency. It is an example of the application of incentive-based regulation to the cost of debt parameter and in this respect, it is preferable to the AER's current methodology. We commend the AER for having collected this data and considered how it can be used in the best interest of consumers. We also suggest the AER should investigate other evidence of debt optimisation strategies.

We note that the EICSI is compiled from confidential data received from the networks. This is necessarily not transparent to consumers and their representatives, so it is not replicable or predictable. Accordingly, consumers and their representatives are required to place a higher degree

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[1] Australian Energy Regulator, *Draft working paper on energy network debt data*, June 2020. https://www.aer.gov.au/communication/draft-working-paper-on-energy-network-debt-data

of trust in the AER's choices. Our preliminary research with consumer advocates indicated they, at least, are willing to place a higher degree of trust in the AER's choices. However, some tension is apparent, with ongoing concern that the regulatory framework is biased in favour of investment over minimising prices. This may be a legacy of the framework's operation before the removal of merits review and changes to the rules around how networks are regulated.

Use of the EICSI, including in conjunction with the existing 10-year trailing average approach, brings an additional layer of complexity to the approach to estimating the cost of debt for a benchmark efficient entity. Asymmetry of information and resources mean that complexity in a regulatory framework inherently favours networks, especially if it allows them to prosecute frequent changes to the methodology.

However, complexity and lack of transparency do not inherently compromise consumer confidence in this process. Overall, and consistent with the views of those consumer advocates we interviewed, we support the AER using the EICSI as a material input into its estimation of the cost of debt and encourage the AER to continue the development of this index.

Table of Contents

1. CRG purpose and objective

Energy costs can represent a significant expense for residential households and businesses. Research obtained from Energy Consumers Australia (ECA) and the Australian Competition and Consumer Commission (ACCC) indicates that:

- The average electricity bill for small to medium sized businesses ranges from just under $6,000 per annum in Queensland to almost $8,000 in South Australia.[2]
- Electricity bills are the second highest concern for households after mortgage or rent payments.[3]
- Network costs represents over 40% of consumers' final electricity bills.[4]

The Consumer Reference Group (CRG) for the Australian Energy Regulator's (AER) Inflation Review 2020 and Rate of Return Instrument 2022 was appointed by the AER in June 2020. The CRG's role is to help the AER implement an effective consumer consultation process; act in an advisory capacity to help inform the AER's decisions with regards to consumer interests; and provide inputs and challenge which might not come through other means. Accordingly, the CRG has developed some initial overarching objectives and principles for formulating views in its submissions.

CRG members bring a wealth of experience across consumer advocacy, research and engagement, and economics, finance and regulatory decision making and will use their expertise to gather evidence of consumer views to inform the CRG submission and presentations to the AER. This includes technical experience and experience consulting with consumers and their advocates as well as reviewing existing consumer research, and other evidence of consumer preferences and expectations. Table 1-1 shows the composition of the CRG. Further details of the CRG members are found on the AER's website[5].

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[2] Alviss Consulting & Energy Consumers Australia, *Analysis of small business retail energy bills in Australia*, October 2017, p. 7. https://energyconsumersaustralia.com.au/wp-content/uploads/SME-Retail-Tariff-Tracker-Preliminary-Report-October-2017.pdf

[3] Essential Research, ECA, *Shock to the System: energy consumers' experience of the Covid-19 crisis*, June 2020, p. 4. https://energyconsumersaustralia.com.au/wp-content/uploads/Shock-to-the-System_-energy-consumers-experience-of-the-Covid-19-crisis-the-numbers.pdf

[4] Australian Competition and Consumer Commission, *Inquiry into the National Electricity Market*, November 2019, p. 39. https://www.accc.gov.au/publications/inquiry-into-the-national-electricity-market-november-2019-report

[5] Australian Energy Regulator, *Consumer Reference Group*, n.d. https://www.aer.gov.au/about-us/stakeholder-engagement/consumer-reference-group

Table 1-1: CRG for inflation Review 2020 and Rate of Return Instrument 2022

Name	Position
Craig Memery	Chair
Allan Asher	Member
Helen Bartley	Member
Ron Ben-David	Member
Kieran Donoghue	Member
Lynne Gallagher	Member-ECA representative
Bev Hughson	Member
Alex Oeser	Member
Jo De Silva	Member

1.1. The CRG's approach in this submission

The CRG was appointed to assist the AER to implement an effective consumer consultation process for the Inflation Review 2020 and making of the proposed Rate of Return Instrument 2022. In doing this, the CRG's overarching vision is that:

The regulatory framework must ensure that only efficient costs are borne by consumers and that in the long-term, productivity and efficiency will reduce prices.

As such, the CRG expects that any changes proposed or considered by the AER:

- produce unbiased outcomes;
- are impervious to stakeholder gaming to favour their own interests; and
- are in the long-term interests of consumers, informed by evidence of consumers' needs, expectations and preferences.

While this working paper is highly technical, the CRG believes the AER must consider how a change in the way the cost of debt is set could impact consumers. For this submission we focused on the specific issues raised in the AER's working paper[6]. In 2021 the CRG is proposing to consider the broader context of the cost of debt and the overall Rate of Return Instrument.

So while we are not seeking a fundamental change to the AER's approach, we reserve the right to consider such changes as part of the Rate of Return Instrument Review, including the circumstances in which we would recommend any changes that would require a change to the rules or law.

[6] Australian Energy Regulator, *Draft working paper on energy network debt data*, June 2020, https://www.aer.gov.au/communication/draft-working-paper-on-energy-network-debt-data

The CRG considers the thresholds for making such changes should be as follows:

- They must best support the long-term interest of consumers.
- They are based on evidence of consumer interests and preferences that align with those changes.

Either way, the CRG's aim is to either support the current approach or recommend changes in line with consumers' interests that can be achieved within the current rules and law.

1.2. What principles does the CRG apply to inform its recommendations?

The CRG has developed some consumer-oriented framework principles, to be refined during the review as we expand our evidence of consumer needs and preferences. The CRG has considered the areas where consumers can meaningfully engage in a potentially highly technical debate about individual parameters within the overall building block approach to setting allowed revenue. Ultimately, consumers care about the impacts of regulatory decisions on the prices they pay and the services they receive[7]. However, they are unlikely to care directly about the specific composition of a debt index used to estimate a network's cost of debt. It follows that their attitudes to regulatory decision making and in particular to each of the myriad sub-decisions that go to make up the overall prices they pay, are more likely to be based on their confidence and trust in the regulatory process, than understanding the detailed analysis that lead to each sub-decisions. This is particularly the case for subject matter such as evaluation of the EICSI, especially as it is based on confidential data.

Our framework principles, which have informed both our consumer engagement and our methodology assessment, are listed below and set out in more detail in Appendix A.

Principle 1 - A regulatory framework serving the long-term interests of consumers must promote behaviours that engender consumer confidence in the framework.

Principle 2 - Any change to the regulatory model must be tested against consumer impacts in relation to absolute prices and price changes.

Principle 3 - Any change to the regulatory model must be tested against acceptable consumer impacts in relation to service standards.

Principle 4 - Risks should be borne by the party best placed to manage them

1.3. Where does the CRG provide input at this stage of the AER's review?

For this submission the CRG has:

- Undertaken some preliminary research on consumer preferences with consumer advocates with respect to trade-offs between different methodologies for estimating networks' cost of debt (Chapter 2, Appendix B).

[7] This is apparent in various research reports commissioned by NSPs, advocates and other agencies. For example, the ECA has been monitoring consumer satisfaction with value for money and reliability biannually over nearly five years in its *Consumer Sentiment Survey*, recognising the significance of price and service on consumer sentiment. https://energyconsumersaustralia.com.au/wp-content/uploads/Energy-Consumer-Sentiment-Survey_June-2020.pdf

- Applied our broader knowledge of consumer preferences and experiences, to supplement what we learnt from preliminary research, so as to form a view about how consumer preferences inform cost of debt considerations (Chapter 2).
- Applied principles of good regulation to evaluate the issues raised by the AER in its working paper (Chapter 3). These principles and their application are informed by the results of our preliminary research.
- Considered the broader context of the regulatory framework and how the cost of debt estimate fits into it (Chapter 4).

2. Consumer perspectives

Since its inception and this submission deadline, the CRG has been working on developing a strategic framework for consumer engagement. In the interim, the CRG developed the following approach to engage with a small number of consumer advocates to gather at least some evidence of consumer perspectives. This approach involved the following:

- ensuring familiarity with the issues covered in the reviews, and with other stakeholder perspectives;
- developing relevant questions and background material;
- gather evidence of consumer perspectives; and
- feeding this evidence back into the review processes

The CRG implemented a targeted engagement program involving semi-structured interviews with four consumer advocates from different organisations representing different consumer perspectives. This was supplemented by some members' experiences representing and interpreting consumer perspectives in previous reviews and their experience in other regulatory contexts.

The CRG's strategic approach to consumer engagement for future submissions is likely to include a combination of direct consumer research and engagement activities involving other stakeholders, and provision of advice to the AER around additional consumer engagement activities beyond those that the CRG and ECA can resource.

For this submission, we have sought to illustrate the variety of views of consumer advocates based on their own experience and their understanding of the views of their particular consumer constituencies. We have taken these views into account in forming our CRG conclusions on the role of the EISCI in setting an efficient cost of debt.

2.1. Background

Prior to the CRG's submission to the AER on inflation, the CRG interviewed six consumer advocates. These interviews provided some initial insights into consumer preferences (as represented by these advocates) while also highlighting the challenges in obtaining representative and informed responses to more detailed questions regarding the AER's regulatory framework.

The AER's draft working paper[8] also examines in some detail issues around the assessment of the efficient benchmark cost of debt. Given our observations from the initial advocate interviews, we began this second round of interviews with some important high-level questions before considering the more detailed issues raised in the AER's cost of debt working paper.

Seven open-ended questions (listed in Appendix B) covered three consumer-oriented areas of discussion:

- Consumer confidence and trust in the current regulatory framework.
- The trade-off between price, reliability and risk from a consumer perspective.

[8] Australian Energy Regulator, *Draft working paper on energy network debt data*, June 2020, https://www.aer.gov.au/communication/draft-working-paper-on-energy-network-debt-data

- Consumer advocate views on some of the more specific technical issues raised in the AER's working paper, and how they may impact consumers.

The CRG interviewed four consumer advocates, each of whom had some experience with regulatory processes and the impact of energy prices and reliability on consumers. They included representatives from the South Australian Council of Social Service, Major Energy Users, the Australian Council of Social Service and the Public Interest Advocacy Centre. Overall, compared to the CRG's initial interviews to inform its inflation submission, the revised interviewing approach resulted in improved feedback from advocates about their views on the broader regulatory issues as well as specific technical issues.

Throughout these interviews, and consistent with the CRG's observations in our inflation research, trust in the AER's expertise was a key element in consumers' confidence in the overall regulatory framework. The advocates noted that in the past the AER placed too much emphasis on supporting network investment, leading to inefficient allowance for the rate of return, excess network investment and higher prices to consumers now, and in the future.

The advocates all agreed the recent changes to the overall framework (such as the removal of the appeal processes) and the AER's improved consultation processes resulted in more balanced outcomes for consumers. Nevertheless, the advocates suggested the AER should more clearly demonstrate how it has considered consumers' interests in its decisions.

They also highlighted the ongoing problem of asymmetry of information and resources between consumers and their representatives on one hand and the networks on the other. The AER's decisions, and the overall regulatory framework would be enhanced if these resource constraints were more adequately addressed by the AER and governments.

2.2. Overview of responses from consumer advocates

2.2.1. Consumer confidence and trust in the regulatory framework

Our initial interviews with consumers on the AER's assessment approach to regulatory inflation indicated that consumers generally do not have either the capacity or the desire to engage in the detail of the regulatory processes. What is essential to the consumers is that they can have confidence and trust that the regulator is an "expert', acts independently based on the information available and is focussed on delivering outcomes in the long-term interests of consumers. Consumer advocates can also play an important intermediary role for the AER as they may have greater understanding of the detailed issues while being in closer touch with their consumer constituencies.

To achieve this, the AER needs to listen to consumers and their advocates and clearly demonstrate in its decision making how it considered consumers' perspectives. This is particularly important given the asymmetry of information and resources between consumers and the networks.

Reflecting on the AER's performance to date, and the extent this has engendered confidence in the AER's decisions, the consumer advocates variously highlighted:

- The AER's openness to consumer views has improved over recent years, assisted in part by the establishment of the CRG and the AER's Consumer Challenge Panel (CCP).
- However, advocates would still like the AER to take greater account of their views and to explain where and how it has done so. Likewise if the AER does not agree with consumers' views, advocates expect a clear explanation of the AER's reasons.

- Some advocates consider the AER and the regulatory framework are still “biased” towards enabling network investment which can lead to inefficient investment by the networks. One advocate highlighted consumer concern with the framework and the AER’s independence as a result of the “gold plating” of some networks in the past.
- Advocates believe this bias has been reduced with rule changes and the removal of network rights to appeal the AER’s decisions on the rate of return. Enhanced consultation with consumers and their advocates would further improve the general confidence in the AER’s decisions.
- Greater funding of consumer representatives is required for consumers to have a stronger and more informed voice in the process. Limited funding is an important issue for these advocates.

As noted above, addressing the financial and resourcing constraints on consumer participation in the regulatory processes, is important in building competency and promoting informed consumer participation in the AER’s decision making. For example, one consumer advocate noted that most consumers were not aware of the importance of the AER’s rate of return decision, nor understood that headline network price reductions may only reflect reductions in interest rates rather than fundamental improvements in business efficiency. Another advocate highlighted that consumers’ focus was on the retail price and there was not much knowledge of network pricing. A framework that includes well-resourced and informed consumer advocates may assist the AER in communicating the importance of network pricing and the rate of return.

We also sought feedback from advocates on two other framework issues; namely whether:

- The process of the AER reviewing previous decisions, such as the use of the ten-year trailing average was likely to undermine or enhance confidence in the AER’s decision making, and;
- The AER should ‘stand-back’ from the decision-making process to allow the networks and consumers to ‘negotiate’ a rate of return/inflation outcome.

The consumer advocates supported the AER conducting regular reviews of the Rate of Return as they recognised that the environment and information may change over time. As such, regular reviews enhanced confidence in the process. However, some advocates qualified this view, particularly with respect to non-regular reviews (including inflation). For example:

- As an expert regulator, the AER should be the party making a decision on whether there is sufficient evidence to support the need for a review and the scope of such a review.
- There is a risk of the promoter of a review (such as a network) “cherry picking” specific components of the regulatory framework, without considering the overall context.
- Defining how consumers can meaningfully participate in such reviews.

Advocates were asked what role the AER should play in the future regarding decisions on the rate of return approach and parameters. These advocates all expressed the view that, while they expect the AER to take account of any "agreements” between the networks and consumers, they also expect the AER to be the ultimate decision-maker and make its decisions in the long-term interests of consumers. For example, as stated by two advocates:

> *“the AER should have confidence to be the decision maker but must explain why they might have deviated from any agreement between the network and its consumer body.”*

"the AER is more than a mediator between consumers and networks. It is a decision maker and bound by the rules."

Overall, advocates support the importance of an 'expert' AER and consider the AER has a central role in an effective regulatory framework. Their confidence in the AER has been enhanced by recent changes to the regulatory framework and the AER's enhanced engagement with consumers and their representatives. However, further engagement and enhanced resources will be required to address the information asymmetry challenge.

2.2.2. Price, reliability and risk

Advocates agreed that "price" and, more specifically, "affordability", are important to consumers, especially at this time. Network reliability, quality, safety and security were important considerations but not at the expense of efficient pricing. However, some advocates also recognised that this priority may vary across different consumer categories.

Efficient pricing means that the price is commensurate with the value of the services delivered to the consumer. Advocates were sceptical that the current prices were efficient and contended that the current reliability could be provided at a lower price, as illustrated by the following comments:

"Consumers are paying too much for reliability".

"More outages due to weather than the system".

"Trust in the current price is not so much there. Current quality is there but could service be delivered at a lower price".

"The price is way too high in achieving the outcomes" [of reliability, quality, security of supply] … *it must be a fair price".*

Consequently, these advocates saw the supposed trade-off between price and future performance as somewhat artificial, for example:

"I would not trust an intergenerational equity argument presented from a network".

One advocate also explained it was important to assess the trade-off question in an overall context of the regulatory decision rather than on the basis of individual projects or decisions.

It was suggested that if networks were to progress this argument, they needed to provide "strong proof" to the consumers and the AER that such a trade-off was in fact required. One advocate suggested that:

"It's not a simple question of more now or more later" and *"the real question is how you put the money to work".*

One also noted that trade-off and intergenerational equity arguments ignored future risks, such as risks associated with climate change and technology. The regulatory framework and early engagement with consumers should allow time for networks, the AER and consumers to fully explore these issues before decisions are made.

Finally, advocates generally believed that financial and operational risk should sit with the party best able to manage that risk. They considered networks were generally better placed to manage risk. One advocate went further and suggested managing this risk was integral to being a provider of an essential service:

> *"Networks bear the risks. They went into business in an essential service and consumers bear the risks of many other things".*

However, there was less agreement about whether consumers should pay more for bearing less risk. One advocate suggested networks were using this risk/cost trade-off as an *"excuse".* Another advocate suggested that there was "*an upside and a downside"* to this question and that more modelling was needed to demonstrate how prices would change with changes in risk.

2.2.3. Technical question on the measurement of debt

The more technical questions at the end of the interview concerned the role, of the EICSI approach developed by Chairmont in 2017 and updated in 2020, noting that further discussion of this approach is presented in Chapter 3.

For the purposes of these interviews, the CRG interviewers provided advocates with a high-level description of the index and how it differed from the AER's current approach.

However because of the technical complexities of the EISCI, we did not fully explore the role of the index in the AER's decision-making or Chairmont's proposed changes to the index. Rather, we explored whether the advocates preferred debt costs based on overall market yields (for a given credit rating) or debt costs based on industry participants' actual debt costs.

One advocate who had experience with both private company financing and with network regulation stressed the limitations of the AER's current approach and its reliance on credit rating scores to assess the efficient costs of debt for a regulated network:

> "*the regulated network has a lower cost of debt than other BBB+ entities*".

They concluded that the EISCI approach was "*closer to being more equitable*", although this was subject to whether all the debt information that would be relevant to an efficient debt portfolio, such as bank lines of credit and debt tenor, are properly included in the index.

After further explanation of the current and index approach, the other consumer advocates concluded that an "index" based on observations of network industry participants' actual debt costs would, in principle, be preferable to the AER's current approach of using market wide yield data. As one advocate specifically noted, consumers would expect the debt cost allowance to reflect the efficient debt costs of a regulated network rather than the market as a whole.

However, all advocates believed that the incentive properties of the regime should be maintained or even enhanced. In the first instance, this meant the revised approach should not be a simple cost pass-through of individual company debt costs as this would reduce incentives for the networks to adopt more efficient debt raising practices. One advocate summarised their preferred approach as follows:

> [The benchmark efficient debt cost allowance should be] "*truly reflective… of what is prudent*" and it "*still retain the incentive to exceed*".

Another advocate highlighted an incentive framework should ensure debt costs are treated in the same way as capital and operating costs with cost savings flowing through to consumers over time. The AER's current approach to the cost of debt did not achieve this outcome:

> *"The AER's* [current] *process incentivises the networks to minimise their costs of debt but not share the benefit with consumers".*

In their view, the EISCI approach was more correct than the current arrangement as it sets a 'benchmark' cost of debt and provides a greater opportunity to share benefits over time with consumers.

One limitation of the EISCI approach is that the data on individual network debt costs is confidential. Transparency is an important principle to underpin an effective regulatory framework. Therefore, we asked the consumer advocates whether this was an issue for them.

While advocates agreed that transparency in the AER's decision making is important for consumers' confidence in the AER's decision, they also recognised the debt costs of individual firms should not be public. Therefore, the 'confidentiality' of individual company data is acceptable, provided the AER has the opportunity to review the raw data and the AER follows regulatory best principles in its assessment.

It does mean, however, that the AER should compare the output of the 'index' on the cost of debt to other available market data and this assessment process should be as transparent as possible. As one advocate stated, confidentiality was not such an issue here "*as long as the AER is transparent on why, what and how they have used the data*".

Ultimately, consumer acceptance of the index will rely on consumers having confidence in the AER's role as an expert independent regulator and that the AER's decisions take full account of consumer views.

2.3. CRG analysis of consumer perspectives

The four interviews aligned with CRG experience of consumer attitudes and preferences. For example, consumer submissions during the development of the Rate of Return Instrument 2018 demonstrated that consumers believed that too much emphasis was being placed on network investment, at the expense of lower prices for consumers. The CRG is aware of the challenges posed to the AER in determining the appropriate balance between investment and prices, and the inevitable tensions this creates between the AER and stakeholder groups, including consumers.

The consideration of the balance between network investment and prices by the AER is one factor which contributes to the perception by consumers of how much trust can be placed in the AER. However, other factors also are in play. The extent to which the AER is open to review, the way in which the AER references consumer perspectives in its decisions, the AER consumer engagement processes and the extent to which decisions reflect the long-term interests of consumers are all also considerations which impact on trust. As reported in the CRG submission on inflation, some consumers are also more inclined to trust government (including the AER).

In our preliminary research, consumer advocates were willing to support the index despite less transparency because on balance, they had sufficient trust in the AER to review the raw data and follow regulatory best principles. This aligns with the CRG general expectations of consumer preferences in this regard.

3. Evaluation framework and preliminary views

We have used our consumer-oriented framework principles (Chapter 1, Appendix A) as the basis for developing an evaluation framework against which the issues raised in the AER's working paper can be assessed.

Drawing on the CRG's second principle ***Any change to the regulatory model must be tested against consumer impacts in relation to absolute prices and price changes*** we consider the potential price impact of using the EISCI. In the context of the cost of debt, we consider that consumer prices should reflect an *efficient* cost of debt. The efficient cost of debt may rise or fall over time, and so we cannot evaluate methodologies on the basis of delivering higher or lower prices per se.

Drawing on the first principle ***A regulatory framework serving the long-term interests of consumers must promote behaviours that engender consumer confidence in the framework*** we have considered criteria that can affect consumer confidence: simplicity, transparency, predictability and stability. The way in which each of these criteria can enhance or undermine consumer confidence is explained further in 3.2 to 3.5 below.

The third principle ***Any change to the regulatory model must be tested against acceptable consumer impacts in relation to service standards*** has only an indirect relevance to the issues in the working paper. The cost of debt does not in itself drive service standards. However, if the overall rate of return is too low to support investment, then this *could* over time lead to a deterioration in service levels. This is explained further in Chapter 4.

The fourth principle ***Risks should be borne by the party best placed to manage them*** is not considered in detail as it is self-evident that networks are better placed to manage their own debt costs than consumers. The issue of whether consumers *could* benefit from accepting more regulatory risk through lower overall prices is best considered holistically in the full rate of return review.

Table 3-1 below summarises our assessment of the index against the current approach (a ten-year average of ten-year bonds, weighted 1/3 A rated bonds and 2/3 B rated bonds).

Table 3-1: Evaluation of cost of debt methodologies from consumer perspective

Criteria	Current approach	EICSI (potentially in combo with current)
Price impact	Moderate – tracks market debt costs over time	Has strong potential to deliver efficient prices
Simple	Moderate	Complex
Transparent	Moderate. AER approach itself is transparent, but data providers' methodology is proprietary.	Lack of transparency from consumers' perspective.
Predictable	Not absolutely, but weighted to historical data	Less predictable
Stable	No change	Change from current

While we do not consider it appropriate or meaningful to formally weight the elements of the framework, the price impact on consumers, including the incentive properties of the methodology is a very important element. In this instance, we consider this outweighs any drawbacks identified in the other elements.

3.1. Price impact on consumers

The EICSI as presented on p11 of the working paper suggests that networks have collectively outperformed the current method for estimating their cost of debt. *Prima facie*, this means that partially or in whole factoring the EICSI into future cost of debt allowances would potentially have a positive impact on prices for consumers. This appears to be driven by the following factors:

- The average term of debt at issuance in the EICSI is often less than the 10 years assumed in the current methodology. It reached 6.5 years in mid-2019. Shorter-term debt is typically cheaper.
- Networks appear to choose shorter-term debt when debt premia are higher.
- Recent debt issuances are on average, closer to an A grade credit rating than the benchmark used in the current methodology (1/3 broad A, 2/3 broad B, intended to represent a BBB+ rating).
- While not explicitly noted in the AER's working paper, energy networks may be able to issue debt at a given credit rating for a lower premium than companies in other sectors.

We note that these conclusions may partially depend on when observations are taken. We further note comments by network representatives at the AER's Public Forum held on 29 July that the networks may have concerns with the way the index is constructed, although we would like to see further evidence of these concerns to consider them fully. Finally, we note that history is not always a guide to the future.

In other words, we realise use of the EICSI or a similarly constructed index is not guaranteed to result in lower costs for consumers. Nevertheless, we fully support the AER and Chairmont continuing to extend the index over future periods and to use it as a quantitative input to the rate of return review. The changes to the weighting and the longer series (which will be extended further by the time of its use in any specific revenue determination) allow for the index to have greater weight in this review than in the 2018 review.

We are open to further discussion with the AER as to exactly how it should be used as a quantitative input. At a bare minimum we would expect it to inform the credit rating and the term of debt, but our preference is for it the spread indicated by the EICSI to be used in estimating the return on debt, either alone or in conjunction with the other three datasets already used (Bloomberg, Thomson Reuters and the RBA).

3.1.1. Further EICSI development

Having "crossed the Rubicon" by initiating the process of gathering and analysing actual network debt cost data, we consider the AER should review the data for further potential efficiencies. This could include considering other types of debt that may be lower cost, debt dominated in foreign currency where the all-in cost including hedging currency risk is lower than domestic debt and other financing techniques such as credit-wrapping[9]. To the extent this data has not been collected from the networks, we support the AER extending its information requests accordingly.

The AER has sought feedback on potential adoption of the following adjustments to the EICSI, which were rejected in the 2018 review:

- Inclusion of callable or subordinated debt
- Inclusion of more fees associated with spread estimates
- Exclusion of debt instruments which have previously been deemed upward outliers by consultants.

We do not see a case for change on the three matters raised in the AER's draft working paper[10] and support continuation of the decisions made in the 2018 review and the AER's reasoning at the time.

3.1.2. The application of incentive-based regulation

At its simplest, incentive-based regulation of natural monopolies assumes setting an *ex ante* allowance for revenue (or weighted average prices) that the regulated entity can recover from its customers. The incentive lies in the regulated entity's interest to find efficiencies to keep its costs down, which allows it to make extra profits. This approach is only in the interests of consumers if they benefit in one of two ways. First, if there is an explicit profit-sharing mechanism built into the framework. In the context of the AER's regulation of energy networks this occurs through the cost and service incentive mechanisms. Second, if the regulator is able to use information about the choices made by the regulated entity in one period to better understand what an efficient entity looks like and to factor that into allowances for the next period. Opex benchmarking is an obvious example of this in the AER context.

However, the CRG has seen little evidence of either of these benefits being used in setting the rate of return for energy networks. There is no explicit profit-sharing mechanism. Networks' financing decisions may help inform the gearing level selected by the AER, but the cost of debt and cost of equity are largely treated as exogenous. At most, one could say that the selection of 10-year bonds as the benchmark for debt costs is influenced by networks' financing strategies. However, the development of the EICSI has shed further light on networks' financing strategies and indicates that the average term of debt is shorter than ten years.

The CRG acknowledges possible implications of the way networks choose to raise debt, knowing that regulatory decisions will form part of the index contributing to the calculation of their future revenue. These could in turn undermine the incentive properties of the use of the index. At the AER's Public Forum on 29 July 2020, the Australian Pipeline Gas Association (APGA) argued these implications could be serious and contrary to the interests of consumers. We do not dismiss such arguments lightly but note that incentive-based regulation effectively drives operating expenditure efficiencies, for example. We therefore consider networks and their representatives would need to

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9 Credit wrapping entails paying a premium to an insurance company in order to guarantee the debt such that it can be rated AAA. UK regulated networks have used this technique. Whether or not it is relevant to current Australian energy network debt financing, it is cited as example of the myriad ways in which firms may achieve lower cost of debt.

10 Australian Energy Regulator, *Draft working paper on energy network debt data*, June 2020, p. 19. https://www.aer.gov.au/communication/draft-working-paper-on-energy-network-debt-data

present a highly robust set of well-evidenced arguments to counteract the presumption that incentive-based regulation can be effective when applied to other types of network costs.

We also urge the AER to consider the counterfactual. If none of the benefits of efficient financing, get passed to consumers then that means there is a part of the regulatory settlement that efficiently run networks can systematically outperform time after time. It is not clear to the CRG how such systematic outperformance is in the long-term interest of consumers. At least, under such circumstances, the opportunity for systematic outperformance as well as evidence of the level of outperformance should be important qualitative evidence in considering the fairness of an overall allowed revenue determination.

In conclusion, the application of an index of actual network debt costs to partially or completely determine the cost of debt is closer to incentive-based regulation, which benefits consumers. Accordingly, we prefer the AER to use make quantitative use of the index.

3.2. Predictability

Use of an index does not allow consumers (or networks) to predict the total impact on allowed revenue. However, neither does the current method. Any method largely based on historical outcomes should be partly predictable, and the longer the time series, the less year-to-year change. However, this is a minor consideration overall. Even if a fixed cost of debt was set *ex ante*, other factors mean that the resulting network charges would not be fully predictable for consumers let alone overall bills. This is further discussed in Chapter 4.

3.3. Simplicity

The AER's current approach to determining the cost of debt allowance is relatively complex. At a high level the AER's approach can be described relatively straightforwardly as a ten-year average of ten-year bonds, weighted one-third A-rated bonds and two-thirds B-rated bonds. Even so, this assumes consumers have a working knowledge of financial markets and statistical techniques, such as weighted averages. Not all consumers have such knowledge. Further, this ignores choices inherent in the approach, such as which bond indices to use and a transition from the previous methodology.

Developing the index entails further complexity, associated with further choices related to weighting different terms of debt, considering exclusions of outliers or other debt instruments that may not be a good representation of efficient debt costs. Applying the EICSI in conjunction with another method, such as the current approach is more complex still. As noted above we are not opposed to complexity if it delivers a better outcome for consumers but the drawback is that stakeholders may find it increasingly difficult and costly to participate meaningfully in a debate around the methodology.

3.4. Transparency

The CRG considers, where possible, evidence to support a regulatory decision should be publicly available to enhance consumer confidence in the process. However, we appreciate network concerns around the confidentiality of their actual debt costs. Regardless, the AER should aim to maximise the transparency of the index to instil consumer confidence. Already, the networks have presented an alternative index construction at the AER's public forum. However as the underlying data is not publicly available, consumers are unable to arbitrate between different indices. This means consumers need to be able to trust the AER's judgement.

3.5. Stability

Supported by evidence from consumer advocates, the CRG considers consumer interests are well-served by a stable regulatory framework. Asymmetry of information and resources means the NSPs are better placed than consumers to prosecute arguments supporting changes to the framework and to specific methodologies. Accordingly, the CRG considers the AER should adopt a high bar for changes to the framework.

We are strongly opposed to adopting changes in response to short-term issues at the cost of longer-term predictability and stability of the framework for investors and consumers. Asymmetry of resources means that such changes will tend to be driven by network concerns rather than consumer concerns. If this asymmetry manifests in frequent changes to methodologies or the framework it undermines consumer confidence in the fairness of the process.

Any alternative methodology must clearly demonstrate it better contributes to the National Electricity Objective (NEO) and National Gas Objective (NGO), and this improvement is material over time. However, it is appropriate for the AER to consider changes to a methodology, especially where this is formed by new or more robust evidence as the case with the EICSI. We will further develop our framework for evaluating whether changes are in consumers' interests through the broader Rate of Return Instrument review.

4. Cost of debt in the context of the overall framework

4.1. The cost of debt is only one component of the overall decision

The previous chapter focussed on the specific issues in the working paper. However, it is important, both in evaluating the technical arguments, and in understanding how consumer preferences apply to the issues, to place the cost of debt parameter estimate in the appropriate context. The cost of debt is one of three (or four, depending on how one views gamma[11]) components of the overall rate of return, according to the following formula:

Rate of return = (cost of debt x debt gearing level) + (cost of equity x (1 - debt gearing level))

The rate of return is only one component, albeit the most material component of the overall maximum allowed revenue that the AER determines for each network for each five-year regulatory period. This is the fundamental decision that the AER makes from a network perspective. Accordingly, any arguments about the under-estimation or over-estimation of a single parameter, even a material one such as the cost of debt, should be contextualised to the overall decision. This does not relieve the AER of an obligation to make a best estimate.

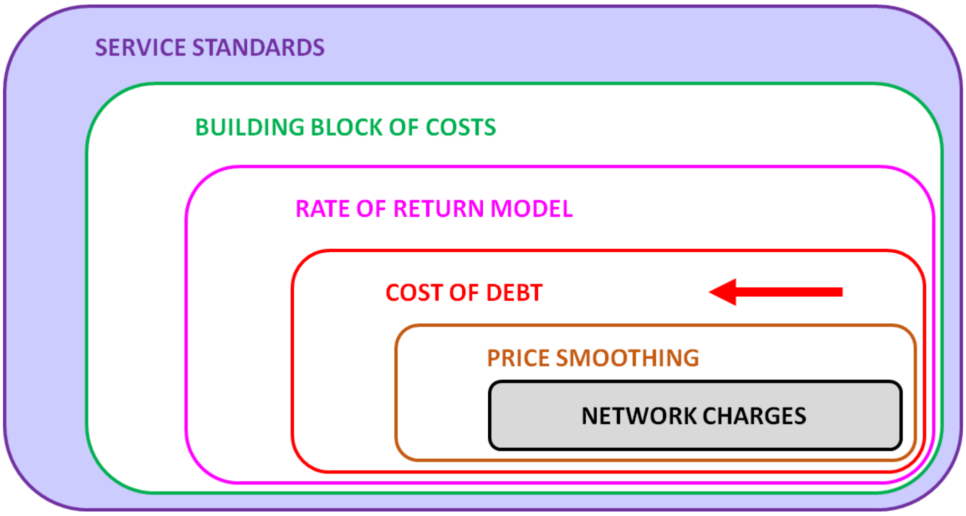
4.2. Customers pay retail bills, not maximum allowed revenue

Consumer perspectives involve two further steps. The networks convert their maximum allowed revenue for each year of the five-year regulatory period into a set of prices or tariffs for network use of system charges (NUoS). Changes in prices may differ from changes in allowed revenue due to demand and other factors. These charges are recovered from retailers who bundle them up with energy costs, AEMO fees, environmental certificate costs and their own costs and margins into an overall bill. Large consumers may see the network component directly, but this is not usually obvious to small customers.

Accordingly, AER's review of the cost of debt is confined to a subset of the total contributors to the two outcomes of interest to consumers, namely service standards and prices. The CRG has contextualised the treatment of inflation to regulatory pricing as show in Figure 4-1 below. This submission focusses only on the scope of the debt data working paper without explicitly judging the merits of the other elements of the regulatory framework or the efficacy of the other costs drivers that contribute to consumer prices.

[11] Technically, gamma, or the extent of dividend imputation is a factor in determining the cost of equity. However, in the regulatory framework it sits outside the "headline" rate of return calculation and is processed as an adjustment to tax.

Figure 4-1: Cost of debt in the context of the regulatory framework



4.2.1. Intergenerational equity issues

Prima facie, service standards have only an indirect link to the cost of debt. However, we note network arguments in the context of the inflation review that

- New investment continues to fall at a time when substantial investment is needed to support the transformation of the energy market.
- Existing infrastructure is aging and investment is required for a new energy future. Under-investment today creates a cost burden for future consumers.

This implies that NSPs believe there is some shifting of costs from consumers today to consumers in the future.

The validity of imputing intergenerational equity issues from debates over rate of return parameters is questionable. As in the inflation review, if NSPs seek to make these claims in the context of the rate of return to review, we expect to see:

- evidence that the AER's approach to inflation/rate of return will lead to underinvestment;
- explanations why this is a legitimate network response when the framework does not guarantee a specific rate of return for any given period, but targets an adequate rate of return over the cycle; and
- credible evidence that consumers would accordingly prefer to pay more now so that future consumers pay less. If networks are seeking to carry out consumer research on their subject, we recommend they seek to work with other parties such as consumer representatives (for example, but not limited to, the CRG) and the AER.

Currently, the CRG has not been presented with any convincing evidence to substantiate these claims. Appendix C sets out some preliminary market evidence that the CRG considers supports the view that networks regulated by the AER remain attractive investments.

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Appendix A: CRG consumer engagement principles

The CRG has developed some consumer-oriented framework principles, which it will refine through the review as we expand our evidence base of consumer needs and preferences. The CRG has considered the areas where consumers can meaningfully engage in what is often a highly technical debate about individual parameters within the overall building block approach to setting allowed revenue. Consumers care about ultimate impact on the prices they pay and the services they receive[12]. They are unlikely to care directly about, for example, the exact composition of a debt index used to estimate a network's cost of debt. It follows that their attitudes to regulatory decision making and in particular to each of the myriad sub-decisions that go to make up the overall prices they pay, are more likely to be based on the confidence and trust they have in the regulatory process than they are to be based on detailed analysis of each of the sub-decisions. Our framework principles, which have informed both our consumer engagement (Chapter 2) and our methodology assessment (Chapter 3), are detailed below.

A1.1 Consumer confidence

It is evident from discussions with Energy Consumers Australia (ECA), that energy consumers have diverse preferences in terms of the price they pay, its stability over time and the service they receive. Accordingly, there is no "average customer" representing a universal consumer preference. We will endeavour to bring these different views into our consideration and to share these with the AER.

Principle 1 - A regulatory framework serving the long-term interests of consumers must promote behaviours that engender consumer confidence in the framework.

This principle focuses on consumer *confidence* rather than consumer *impact*. Whereas impact refers to the outcomes experienced by consumers (typically, through prices and service standards), consumer confidence is derived from the parties' observable behaviours under the regulatory framework. This principle represents an expectation about the conduct of the parties to a regulatory process. In this sense, it goes beyond the standards of conduct implied by usual principles of best practice regulation.

For example, a regulatory process may be conducted openly and transparently in accordance with best practice principles, but if the parties' behaviours suggest repeated attempts at rent seeking, then consumers can reasonably conclude the framework is inviting such behaviours. That is, the framework is inviting behaviours which are contrary to consumers' long-term interests.

A1.2 Impact on prices

Network costs make up a substantial part of a consumer's energy bills. Individual sub-decisions within an overall revenue determination may not have a material impact on bills when taken in isolation, but the cumulative effect of many decisions is.

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[12] This is apparent in various research reports commissioned by NSPs, advocates and other agencies. For example, the ECA has been monitoring consumer satisfaction with value for money and reliability biannually over nearly five years in its *Consumer Sentiment Survey*, recognising the significance of price and service on consumer sentiment. https://energyconsumersaustralia.com.au/wp-content/uploads/Energy-Consumer-Sentiment-Survey_June-2020.pdf

Principle 2 - Any change to the regulatory model must be tested against consumer impacts in relation to absolute prices and price changes

Consumers prefer lower prices, other things being equal. However, we recognise that there can be trade-offs between price and service quality and between price and risk allocation and these are covered in the next two principles.

A1.3 Impact on services

Drawing on its members' diverse experience, the CRG recognises consumers expect certain levels of service quality and reliability, depending on their circumstances. The CRG believes consumers have a fairly good idea of what service levels they expect for the price they are paying but when asked to consider long-term changes or the impact of rare events, they are less likely to be able to reveal their true preferences. This means that in particular in natural monopoly markets, service standards, including reliability are often set by governments. The CRG believes that this trade-off between price and service levels is a fundamental issue where consumer interests are often underrepresented. Therefore, the CRG decided that its third principle should be:

Principle 3 -Any change to the regulatory model must be tested against acceptable consumer impacts in relation to service standards

At the AER's public hearing on inflation on 2 July 2020 and in the Energy Networks Australia submission[13], Network Service Providers (NSPs) expressed a view that the current model of estimating and treating inflation in the regulatory models breaks down in the prevailing economic conditions. NSPs stated that:

- New investment continues to fall at a time when substantial investment is needed to support the transformation of the energy market.
- Existing infrastructure is aging and investment is required for a new energy future. Under-investment today creates a cost burden for future consumers.

This implies that NSPs believe that decisions by the AER that they consider adverse to their overall returns - whether through the inflation component or the cost of debt component – will result in some shifting of costs from consumers today to consumers in the future. It further implies that such decisions can impede the transition of the energy system, which will result in higher costs for consumers in the future. The CRG is concerned that at this stage, no convincing evidence has been produced to substantiate these claims.

A1.4 Efficient risk allocation

One way to achieve lower costs to consumers in line with principle 2 may be to transfer more risk to them. Imposing risks on consumers that they cannot directly control, may, in the long run, result in higher costs to society, without actually improving the quality and reliability of services The CRG believes consumer's interest should be expressed in a fourth principle as follows:

Principle 4 -Risks should be borne by the party best placed to manage them

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13 Energy Networks Australia, *A hybrid approach that has regard to market data*, July 2020. https://www.energynetworks.com.au/resources/submissions/2020-submissions/response-to-aer-discussion-paper-regulatory-treatment-of-inflation/

One way to achieve lower costs to consumers may be to transfer more risk to them. In the case of the cost of debt, though, networks are clearly the party best place to manage the risks of fluctuating finance costs. Accordingly, we will consider carefully whether proposed changes to setting the cost of debt entail such a risk transfer, whether any such risk transfer is in consumers' best interest and how we can elicit their views on such a trade-off.

In setting an ex ante real rate of return, the AER provides discretion to the networks to determine their preferred financing structures, which is central to incentive regulation. It means that networks bear some risk around financing conditions not matching the *ex-ante* assumptions. To the extent these are systematic risks (roughly speaking, economy wide risks) the networks are compensated for this risk through a non-zero equity beta.

Concurrently, from a consumer perspective, the incentive regulation regime should mean that consumers pay no more than the efficient cost of financing the ongoing provision of services. This generally means it is more efficient to compensate businesses through the rate of return for financial risks rather than shifting these risks to consumers when they are unaware or unable to manage these financial risks even if the risk transfer results in lower prices due to a lower beta. However, the AER's approach to the estimate of beta is largely predicated on historical observations of relevant listed companies and so this approach may not be amenable to adjustment for forward-looking transfers of risk based on the design of the regulatory settlement.

Appendix B: CRG interviews with consumer advocates

The CRG's decision to engage with consumer advocates is consistent with the AER's 2017 Stakeholder Engagement Framework[14]. In the AER regulatory approach cycle, the CRG's engagement fits in to the "consumer insight" and "ongoing stakeholder dialogue" components. Consumer advocates are viewed as being AER stakeholders who also have consumer insight. The CRG engagement approach in these interviews was aligned to the AER's principles-based approach.

The interview questions were developed collaboratively by CRG members. The CRG is further considering how best to engage with consumers on the Review of Inflation 2020 within the CRG work program over the next five months.

At least two CRG members were present at all interviews. A list of interviewees and interview questions are provided below. The interviews were conducted via web conferences. Each interview lasted for around one hour.

Appendix B1. Participants

Interview date	Name	Organisation	About
5/8/2020	Miyuru Ediriweera	Public Interest Advocacy Centre (PIAC) https://piac.asn.au	PIAC conducts test cases and strategic litigation in the public interest, and provides legal assistance, policy advice and training focused on the disadvantaged and marginalised.
30/7/2020	David Headberry	Major Energy Users (MEU) http://meu.asn.au/about.html	In 2005, the MEU brought together a number of regional energy advocacy groups representing the interests of large consumers of energy.
30/7/2020	Georgina Morris	South Australian Council of Social Service (SACOSS) https://www.sacoss.org.au/	SACOSS is the peak body for the non-government health and community services sector in South Australia.
31/7/2020	Kellie Caught	Australian Council of Social Service (ACOSS) https://www.acoss.org.au/about-us/	ACOSS is a national advocate supporting people affected by poverty, disadvantage and inequality, and the peak council for community services nationally.

14 Australian Energy Regulator, *Revised Stakeholder Engagement Framework,* September 2017, https://www.aer.gov.au/publications/corporate-documents/aer-stakeholder-engagement-framework-2017

Appendix B2. Interview questions

1. What do you expect from the regulatory framework in order to have confidence in it?
2. Is price an important priority for the consumers you represent? What else is important/ are these more important than price/about the same or less important?
3. Do you have views about the price - service quality/reliability trade-off and particularly what this means over a long-term horizon?
4. Are consumers placed to be able to manage financial risks if it means lower prices? For example, currently, the networks take some of the risk on inflation, would you accept that consumers be exposed to all of this risk if you had lower prices?
5. The AER used a modelled efficient benchmark cost of debt estimate - as a background, the estimates the AER is using now, are all calculated estimates and not real market observations. The AER is considering using an efficient benchmark estimate based on observations of actual market data. Would you have more confidence in this type of approach?
6. The movement towards enhanced market data by the AER may mean less transparency. Do consumers have concerns about data sets being confidential?
7. Do you have any other views on the technical issues the AER is raising in the debt paper?

Appendix C: Market evidence

Given concerns expressed by the networks in regulatory processes such as this one, the CRG considers it useful to consider the information that is currently available regarding the networks' current and forecast financial position.

The CRG is aware that of limitations in drawing strong conclusions from the financial data, particularly in the context of the current market volatility and uncertainties arising from the COVID-19 pandemic. For this reason, our observations and conclusions are preliminary. However, based on a variety of market information sources taken together:

- There is no indication of networks experiencing financial distress, and the observed trends in real returns on assets are consistent with the declining costs of funds.
- While dividends to equity holders are expected to decline slightly in 2021 compared to the 2019-20, there are multiple factors other than the regulatory settings that are contributing to this such as COVID-19, expected future investments in regulated and non-regulated assets.
- There is some evidence of a network desire to expand their regulatory asset bases, for instance in response to the expansion of transmission networks anticipated by the ISP process.
- The ongoing high sale prices and RAB multiples for network assets observed in a recent $2B (plus) purchase of a 19.9% stake in TransGrid.

In making these observations, the CRG has drawn on the following sources:

- **AER *Electricity Distribution Network Service Provider Performance Data*[15]**

This data demonstrates that the return on assets has declined over the period 2014 to 2018. This is in line with general reductions in financing costs for debt and equity. As of 2018, the real pre-tax WACC for the electricity networks clustered around 4% - 4.5%. Although the data in this report was only up to 2018, the networks had already raised the issue of inflation estimation from 2016/17.

- **Spark Infrastructure, Annual Report 2019[16] and APA Investor Presentation.**

These reports express some concern with the impact of lower rates of return on future earnings, but they appear to remain optimistic in terms of expected distributions to equity holders for the forthcoming year. This is somewhat surprising given the repeated claims of negative returns to equity arising from the AER's treatment of inflation.

In its Annual Report, Spark Infrastructure reported that its 2019 distribution of 15c/security was "fully funded by net operating cash flows".[17] It also retained its half-year guidance for 2020 of 13.5c/security. Spark states that: [18]

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[15] Australian Energy Regulator, *Electricity Distribution Network Service Provider Performance Data*, August 2019. https://www.aer.gov.au/system/files/Electricity%20Distribution%20Networks%20Performance%20data%20report%20-%202006-2018%20-%20PDF_2.pdf

[16] Spark Infrastructure, Annual Report, 2019. https://www.listcorp.com/asx/ski/spark-infrastructure/news/2019-annual-report-2296618.html

[17] Ibid, p 51.

[18] Ibid, p 57.

"[The 2020 distribution is] expected to be covered by look-through net operating cash flows consistent with prior years with Spark Infrastructure having achieved an average payout ratio of 71% over the last five years."

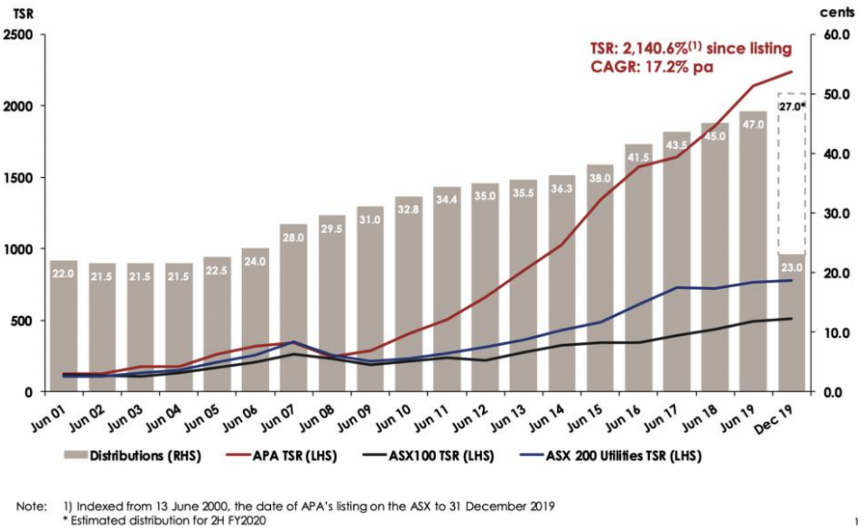
In its most recent presentation to investors, the energy infrastructure business, the APA Group reported 2020 half-year results consistent with recent full year results for the 2019 and 2018 financial years. For example, using data from the "5-year financials" table, the APA group reported as follows in Table C1[19]. However, we also recognise that the APA results include both regulated, lightly regulated and non-regulated business operations.

Table C1: APA Group

Indicator	Half year 2020	Full year 2019	Full year 2018
Operating cash flows ($m)	511.9	1,012.1	1,031.6
Earnings per security (cents)	14.8	24.4	23.3
Operating cash flow per security (cents)	43.4	85.8	90.7
Distribution per security (cents)	23.0[1]	47.0	45.0

Additionally the APA Group forecast a full year distribution per security of 50 cents/security[20]. APA's presentation also demonstrated that total shareholder returns had increased above the ASX 100 for the last 10 years for APA and, more relevantly, the ASX utilities index. This is illustrated in in the following figure.[21]

Figure C1: APA distributions and TSR returns



[19] APA Group, *Investor Pack*, February 2020, p 18. https://www.apa.com.au/globalassets/asx-releases/2020/investor-pack-1h-fy20.pdf.

[20] Ibid, p. 12.

[21] Ibid., p 13.

- **TransGrid purchase (May 2020) and RAB multiples**[22]

In May 2020 that the Canadian Pension Fund (OMERS) confirmed that it had agreed to purchase a 19.9% stake in TransGrid, for some $2 billion or more (subject to Foreign Investment Review Board approval). OMERS is one of Canada's largest pension funds and it is reasonable to assume that offer was made with full awareness of the Australian regulatory environment, the AER's Rate of Return Instrument and the AER's treatment of inflation.

It is estimated that the purchase offer of at least $2 billion represented a multiple of 1.8 on TransGrid's regulatory asset base and 1.6 on TransGrid's regulatory and contracted asset base. [23] This result is in keeping with the initial sale of TransGrid in 2015 at a RAB multiple of 1.5 to 1.6. This result also suggests that despite the regulatory and economic developments since 2015, investors seeking long-term reliable returns are still willing to invest in the network assets at a sale price premium.

To conclude, the market-based information does not yet suggest that existing equity holders are materially exposed, that the businesses cannot meet their debt payments or that new investment is being withheld.

[22] Australian Financial Review, "Spark nervous about regulatory settings for COVID recovery", 27 May 2020. https://www.afr.com/companies/energy/spark-nervous-about-regulatory-settings-for-covid-recovery-20200527-p54wsb

[23] Australian Financial Review: "TransGrid investors pass up rights, ready to welcome OMERs", 1 April, 2020. https://www.afr.com/street-talk/transgrid-investors-pass-up-rights-ready-to-welcome-omers-20200401-p54fv7