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Paula Conboy
Chair
Australian Energy Regulator

Draft Rate of Return Guideline

Dear Ms Conboy,

As the national voice for residential and small business energy consumers we appreciate the opportunity to participate in Australian Energy Regulator's Review of the Rate of Return Guideline and to comment on the Draft Rate of Return Guidelines: July 2018 and the accompanying Explanatory Statement (Statement).

Since being established by the Council of Australian Governments Energy Council (the Energy Council) in 2015, we have considered carefully our objective, which is to promote the long-term interests of energy consumers with respect to price, quality, reliability, safety and security of supply. We conclude that the long-term interests of consumers are served when current and future consumers pay no more than they need to for the quality of service they require.

Central to achieving this objective is the development of effective competition in markets where competition is viable, and best practice regulation of natural monopoly services where competition is not viable. Network regulation must be designed to provide incentives to networks to improve their performance, while constraining their prices within an efficient cost of service envelope.

Our overall response to the Draft Guideline is that the evidence available to the AER justifies the choices made in the Draft, indeed we believe the evidence supports a lower rate of return lower than proposed by the Draft. We do, however, acknowledge and support the AER's concern that movement in the rate of return should not be too extreme in any individual review so that investor confidence is not unnecessarily disrupted.[1]

We are therefore disappointed by Energy Networks Australia's response to the Draft. Heading into the review ENA advised that it was seeking from the AER a Guideline that was 'capable of acceptance.' In our more recent conversations with the ENA it has indicated that the Draft is 'not capable of acceptance', based on a perception that the draft is not 'evidence based' by which they mean 'changes in decisions being in line with changes in evidence.'

As we show in more detail in the attached submission, the direction of the AER's decisions in relation to two key parameters (beta and Market Risk Premium) are all supported by the evidence.[2] Indeed, we note that the evidence before the AER would have justified it going further. We infer that the AER's approach in not doing so was motivated by the desire to maintain investor confidence; this caution on behalf of the AER we believe has delivered a Draft that is 'capable of acceptance' by all parties.

Concurrent Expert Evidence Sessions and Independent Panel

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[1] As noted on page 29 of the *Draft rate of return guidelines: Explanatory statement* and in previous decision, for example, page 3-165 of the *Transgrid transmission draft determination 2018-23.*

[2] We also support the Consumer Reference Group view that the evidence also supports the AER's decision on gamma and that the AER would be justified in raising it further, however, we do not advance those arguments in this submission.

The Review made use of two process innovations that are now to be incorporated in the Binding Instrument legislative changes – Concurrent Expert Evidence Sessions (CEES) and an independent panel (Panel).

In our submission we explore the lessons from this experience, particularly in relation to the conduct of the CEES that varied substantially from the approach outlined in the AER's Position Paper on the conduct of the review. We also discuss:

- How to better engage experts after the sessions and why the AER should place greater reliance on the evidence provided at the sessions rather than in the facilitator's report.
- The Panel's valuable insights about how the AER can improve the explanation that accompanies its Guideline in its report. We endorse the Panel's view that the explanation should be relatively self-contained and not require a long historic engagement with the issues to be comprehensible.

We note that it is our interpretation of the Panel's report that the AER Draft is based on the evidence and that what can be improved is the explanation of its reasoning rather than the reasoning itself.

We also believe there is value in the AER undertaking a 'post-implementation review' of these innovations to enhance the effectiveness of future reviews. There is also an opportunity to consider how these new approaches could be applied in other aspects of the AER's work.

Responding to Energy Networks Australia

Energy Consumers Australia is keen to move beyond the adversarial approach to economic regulation. While we note that the evidence before the AER justifies a lower overall Rate of Return than is proposed in the Draft, we are disposed to encourage the AER to adopt the Draft for the final guideline.

Our view is that the AER has considered all the evidence, including the outcomes of previous decisions, and has in the Draft aligned the interests of consumers and investors in outcomes that reflect the risks faced by both parties.

If as a consequence of the networks' opposition, the AER reconsiders the judgement it has made on any matter, we submit that the AER place less emphasis on providing investor interests and more on the empirical data available. We contend that this would result in a lower rate of return than provided by the Draft.

In making this submission we are not simply engaging in the process of making ambit claims. Energy networks have been historically over-compensated for their investments. We simply note that had the AER used the same judgement it has in this Guideline in 2013, energy consumers would have paid $340 million less in network charges per year.

Incremental Review

The AER proceeded with the Review on the basis of it being an 'incremental approach.' In my letter to you of 22 December 2017 that accompanied our submission in response to the issues paper for the Review I agreed that it was useful to build on the foundations of the 2013 Guideline. Many of the issues had been subject to multiple reviews, and the conclusions of all those reviews had supported the AER's approach.

Central to that approach is the continued use of the Foundation Model. This is a specific approach to the calculation of the Equity Risk Premium that responded to propositions that four different approaches should all be used by the AER, including in one submission a well-articulated but not well reasoned method for deriving one value from the four methods. The foundation model very simply stated that the AER would adopt the Sharpe-Lintner Capital Asset Pricing Model (the SL-CAPM) but that in determining the equity beta it would be informed by the Black CAPM and in determining the MRP it would be informed by the Dividend Growth Model (DGM).

In the Statement the AER says it has ‘diminished confidence’ in the DGM (P.44) and in the Black CAPM (P. 52). In the case of the former Energy Networks Australia notes the AER concerns are not new and that as a consequence the AER should not adjust its view. The AER in response notes ‘multiple submissions’ have highlighted that these issues have been further illuminated since 2013. Not least among these is the sensitivity of the DGM to growth rate selection. In the case of the latter the AER has agreed with CCP16 that there is uncertainty around empirical estimates of the Black CAPM and it is not generally applied by market practitioners or regulators.

We agree with the AER that this is new information that is relevant for making the Draft and that it is not inconsistent with the intent of an incremental approach. ENA has indicated that had it known the AER might change the way it allowed the Black CAPM and the DGM to ‘inform’ the SL-CAPM that they would have introduced more evidence in support. Energy Consumers Australia does not agree with the networks that the AER’s approach is inconsistent with the incremental approach.

In addition, we believe that the networks have placed too great an emphasis on the ‘false precision’ inherent in all versions of the CAPM. Consequently, the networks perceive that the only information that can inform the regulator is market estimates of parameters. Energy Consumers Australia noted in our submission to the issues paper that it is important for the regulator to consider the totality of the allowed Rate of Return and not just the component parts.

These two points were emphasized by Professor Johnstone at the first concurrent expert evidence session; he emphasized the need to consider the outcome of previous decisions. The latter point was also raised by Martin Lally at that session, with particular reference to the way the Commerce Commission of New Zealand estimates the consequences of a too high or too low estimate.

In considering the rate of return as a whole the AER is making two observations. The first is that the allowed rate of return has been too high. Secondly that consumers have expressed a willingness to bear a higher risk of reliability in return for lower prices. Each of these is explicit new information to be considered in the application of the Foundation Model. Because the AER is required to choose estimates of the individual parameters, in reaching the conclusion that the rate of return needs to be lower it is reasonable to conclude that less weight should be given to the two explicit factors that had been used to choose higher points in the range in the 2013 Guideline, namely the Black CAPM and the DGM.

Future Reviews

Notwithstanding our support for the AER’s implementation of the incremental approach for this review, as outlined in my letter of December, Energy Consumers Australia is not confident the use of the current model is sustainable for future reviews of the Guideline. Presumably the legislation that will make the guideline a Binding Instrument will remove the burden of AER staff who work on Rate of Return issues from having to write voluminous reports for every decision (and review and appeal).

We believe that the AER should commence a review starting in early 2019 of how additional information, including profitability outcomes, can be used to inform future decisions.

We note that the Consumer Reference Group provided some material that could help initiate that review in its submission following the Concurrent Expert Evidence Session.

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Yours sincerely
Rosemary Sinclair AM
Chief Executive Officer