AUSTRALIAN ENERGY COUNCIL

10 March 2022

Mr Warwick Anderson
General Manager, Network Pricing
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

By email: RateOfReturn@aer.gov.au

Dear Warwick,

Rate of Return – Information Paper and Omnibus Papers.

The Australian Energy Council (AEC) welcomes the consultation opportunity in the Australian Energy Regulator (AER) Rate of Return Information Paper and Omnibus Papers.

The AEC is the industry body representing 22 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

Taken as a whole, the AEC generally support the AER's positions outlined in the paper. We also note that there are critical areas where the AER haven't yet formed a preferred view, and are open to further consultation. Of those areas where the AEC has not yet formed a preferred view, the AEC sees the following areas as critical:

- Return on debt;
- Risk free rate;
- The Beta, and;
- The Market Risk Premium (MRP) and Dividend Growth Model (DGM)

We see these as all critically important to consumer outcomes. All costs, regulated or otherwise, will eventually find their way through to consumers and each of these contribute more or less significantly to overall regulated costs.

Return on debt

The return on debt is estimated as a ten year trailing average to reflect the fact that the cost of debt is a function of the previous ten years. Our observation of the published expert testament is that outperformance against the current trailing average is small, and generally cited within 4-10 basis points (some experts point to -1 to 3 basis points). Observations did not seem to point to outperformance that was economically significant. The expert testament did broadly agree that the cost of debt was not best based directly on index outcomes.

In light of the evidence that has been presented throughout the consultations and the various contentions on return on debt, the AEC supports an approach that;

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1. Sticks with the trailing average, and;
2. Monitors outperformance.

The AEC does not believe the case for a weighted trailing average has been sufficiently made to trigger such a change. However, we understand that if the AER considered it necessary on an evidentiary as opposed to hypothetical basis, then it may be given effect.

Risk free rate

Broadly speaking, shorter periods are better for consumers as they have lower yield rates than longer periods (five year bonds have lower yields than ten year bonds). However, we estimate that these differences are at the margins if adjusted for the MRP. The AEC therefore does not have a strong view on this proposal.

Beta

Disappearing comparators for beta continue to represent a significant problem. Keeping in old businesses is problematic over time, and in our view overseas data is not a good comparator. We note that the experts also expressed concern with the use of very long run data to estimate betas. We agree with the AER that giving different weight to estimates from different time periods will result in a better estimate.

MRP & DGM

If the DGM is to be used to inform the relationship between the market risk premium (MRP) and risk-free rate, it would appear that any such approach would have to be mechanistic, ie. adjust the MRP with the risk free rate. In such circumstances the AEC would be concerned with the use of the DGM.

The AEC believes that the current approach using the MRP is consistent even if it is not perfect. On our estimation no superior approach has been identified, and there are good reasons identified in the Sapere Report to the CRG[1] to rely on the unconditional MRP.

Any questions about this submission should be addressed to David Markham by email to [redacted] or by telephone on [redacted]

Yours sincerely,

David Markham
Networks and Distributed Energy Resources Policy Manager
Australian Energy Council

[1] This report was co-funded by Energy Consumers Australia and the AEC