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

Dear Warwick

Submission on the AER's Draft Rate of Return Guideline

AusNet Services welcomes the opportunity to comment on the AER's Draft Rate of Return Guideline.

AusNet Services is conscious that this Guideline review is being undertaken at a time when customers have seen significant increases in electricity prices, and energy costs are subject to intense media and political scrutiny. However, for at least the past four years network prices have been falling, as confirmed by the ACCC's Retail Electricity Pricing Enquiry. It is incumbent on the AER, in setting regulated returns for network businesses over the next 5 years, to balance the calls to lower prices in the short-term with an understanding of the long-term damage to the cost of supplying network services of setting an unpredictable rate of return that is not supported by evidence. A rate of return that does not reflect required market returns will not attract sufficient investment to enable network reliability and wholesale market competition to be maintained during the transition in generation sources underway. This will result in poor customer outcomes over the longer term.

Cost of Equity and Imputation Credits

In this context, AusNet Services is highly concerned that the AER is proposing to implement unprecedented cuts to the rate of return, at a time when:

- There have been no major changes in finance theory; and
- Market evidence consistently suggests required returns have increased since the development of its 2013 Rate of Return Guideline.

Early on in the consultation process the AER indicated that:

> *'Based on the available evidence we consider our current* [i.e. 2013] *approach is an appropriate starting point and it has been achieving the national electricity and gas objectives, and the allowed rate of return objective.*[1]'

Given this, it is not clear how 6 months later the AER reached the view that the following material changes would be made to its current approach:

- Applying no weighting to evidence produced by the Dividend Growth Model;

[1] AER, *Does the rate of return achieve the national gas and electricity objectives?,* https://www.aer.gov.au/system/files/AER%20presentation%20on%20achieving%20the%20NEO%20.pdf

- Applying no weighting to the Black CAPM; and
- Changing the methodologies for estimating key gamma parameters, the distribution rate and theta.

The credibility and effectiveness of the process is more important than previously as this Rate of Return Guideline is likely to become binding on the AER and the network businesses. The degree of these changes was unanticipated by stakeholders, including the ENA and network investors, which indicates a weakness in the extensive and thorough consultation process with stakeholders and experts. To continue to attract quality investment into the sector, it is important that the Rate of Return is set in a transparent and predictable way, a fact highlighted in the conclusions of the Independent Panel Review.

Unfortunately, AusNet Services does not consider that the conclusions underpinning the Draft Guideline reflect the consultations, the outcomes of the expert concurrent sessions, or the weight of the evidence put to the AER. Two emblematic examples of this are:

- The proposal to give zero weighting to DGM analysis in setting the MRP after the results of the AER's preferred and long established DGM specifications had increased and converged since the 2013 Guideline; and
- Proposing an equity risk premium that had failed (and was below even the lower bound of) the four long-standing "reasonableness" cross checks the AER has applied and passed at previous rate of return reviews. In addition, the new fifth cross check introduced for this review, the only one passed, had been criticised by the AER in previous reviews.

Therefore, if the Draft Guideline positions in relation to the cost of equity and gamma are maintained, AusNet Services is concerned that the 2018 Guideline process sets a precedent that, even where there are no major changes to finance theory, and market evidence does not support change, the outcome of the review will be unpredictable. This will undermine the confidence of owners of network businesses and chill investment in the sector.

Customers' Desire to Take on More Risk for Lower Prices

The AER's Explanatory Statement contains the assertion that:

> *Consequently, consumers submit that when we exercise judgement in this current guideline process we should do so in favour of a lower, rather than a higher, rate of return. When put in the context of the NEO and NGO, consumer representatives have clearly indicated, during this consultation process, a willingness to accept a higher level of risk in respect of the rate of return and the investment it is intended to promote in exchange for lower prices*[2]*.*

This statement is surprising, and is at odds with the direct customer research AusNet Services has carried out, most recently as part of its 2021-25 distribution revenue proposal development. The inherent characteristics of networks means that an increase in risk (and the deterioration in reliability) will be felt by all customers, not just those who may have views in line with the trade-off outlined above.

[2] AER, *Draft Rate of Return Guideline, Explanatory Statement*, p. 28

In Victoria, where probabilistic planning is employed, investment decisions have a sharp, and quantifiable, price-reliability trade-off. Reducing investment will have a direct consequence on both price and reliability. This Guideline will apply across all jurisdictions and as such it is important that the rate of return is suitable to be broadly applied, without undue customer impacts.

Through our research we understand that business customers in particular can have a very low tolerance to outages – this tolerance varies widely depending on the nature of the business. This is particularly true for small businesses for which it would not be economic to install back-up supply. A recent survey of 200 business customers commissioned by AusNet Services and the Customer Forum established for its distribution price review found that the main driver of satisfaction for 70% of business customers surveyed was a reliable service. While affordability is also a concern to these customers, there was no indication that they would be willing to see a deterioration in reliability for more affordable electricity[3].

Residential customers may be more resilient to outages, as long as they receive accurate communication in relation to the time (if planned) and duration (both planned and unplanned) of these outages. However, there are some types of residential customers, for example life support customers, for whom reliability ifs paramount. Furthermore, residential customers are also indirectly impacted by interruptions experienced by businesses, due to the adverse economic impacts of poor reliability on businesses, for example as they send staff home for the day.

It would seem that the assertion above has been given significant weight by the AER, as the Draft Guideline does not reflect developments in finance theory or updated market evidence. If implemented, the Draft Guideline will have major long term customer impacts. Therefore, it is imperative that there is specific and robust consultation with the impacted customers before such a conclusion is asserted.

Cost of Debt

We strongly support the AER's decision to retain the current debt approach, including the 10 year benchmark term, particularly given that networks are currently transitioning to a 10 year trailing average cost of debt. AusNet Services' debt practices align with this benchmark. This approach was adopted in the AER's 2013 Guideline and is leading to greater stability and predictability in the allowance for debt, and therefore prices, between regulatory periods.

As a package, AusNet Services considers the approach to setting the cost of debt allowance set out in the Draft Guideline is the only component that is capable of acceptance. This includes the AER's decision not to rely on the third party data series published by S&P.

It is not clear whether the AER is considering applying weight to the S&P curve in the final Guideline, as it has published further information provided by S&P during the consultation process on the Draft Guideline. AusNet Services would be very concerned if this was the case, given:

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[3] The results of this survey can be found under Week 6 here: https://www.ausnetservices.com.au/en/Misc-Pages/Links/About-Us/Charges-and-revenues/Electricity-distribution-network/Customer-Forum

- Stakeholders have only had 3-4 weeks to consider the information presented by S&P in responding to the Draft Guideline;
- Stakeholders have not had the opportunity to consider the, as yet unpublished, AER's view of this information;
- The independent review panel is reviewing the Draft Guideline's debt approach without the inclusion of the S&P data, and its conclusions will be drawn on this basis; and
- Stakeholders have been unable to analyse the impacts of the changes made by S&P as the data has not been made available.

Therefore, AusNet Services strongly supports the Draft Guideline decision to not rely on the S&P data series as part of the overall debt approach.

Changes to Averaging Period Conditions

AusNet Services welcomes the ability to propose an averaging period for the cost of equity of up to 60 business days. This will provide for smoother outcomes and greater predictability for both networks and customers.

For debt, the first averaging period selection criteria contained in the Draft Guideline should be changed to avoid restricting the periods during which businesses can raise debt that will be matched to their regulatory allowance.

Therefore, AusNet Services considers that the current criteria:

(a) Finish no earlier than 12 months prior to the commencement of a regulatory year.

Should be changed to read:

(a) Commences no earlier than 15 months prior to the commencement of a regulatory year.'

Table 45 of the AER's Explanatory Statement indicates that the criteria is designed to avoid service providers being forced to raise debt at certain times, and to allow service providers that raise debt as part of a corporate group (such as AusNet Services) to select averaging periods which overlap. This intent has been confirmed in discussions with AER staff. However, the drafting of criteria 18(a) does not give effect to this intent, for the reasons outlined below.

Where a network has short (i.e. 10 business day) averaging periods, under the current drafting the averaging period must start 12.5 months prior to the commencement of a regulatory year, and finish at least 3 months before the regulatory year. This results in an averaging period 'black spot' during 2.5 months of each year.

This is problematic for AusNet Services because:

- Debt is raised across all its three networks simultaneously, so common averaging periods for the three networks are desirable; and
- It has different regulatory years for its transmission network (commencing 1 April) compared to its electricity and gas distribution networks (commencing 1 Jan).

Under the current drafting, 1 October until mid-Dec would be unavailable to apply to its transmission network and 1 July until mid-September would be unavailable for the electricity and gas distribution networks. Therefore, if AusNet Services wished to nominate common averaging periods for its three networks (as is current practice), only mid-December to 30 June would be available. Changing the drafting as suggested above would retain the ability to select an averaging period during any month of the year.

This modification is price neutral for customers, but will help AusNet Services control its costs. As it issues a long term, staggered debt portfolio in line with the benchmark debt approach, the timing of debt maturing over the next 10 years is already fixed. This timing does not always fall in mid-December to 30 June. Where this is the case, AusNet Services is unable to match its averaging periods to its debt maturity and therefore issuance dates for all three networks, which will require it to take on more interest rate risk, as it is unable to match its debt costs to the debt allowance.

Please contact Charlotte Eddy, Manager Economic Regulation on [redacted] with any questions in relation to this submission.

Sincerely,

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Tom Hallam
General Manager Regulation and Network Strategy
AusNet Services