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Dear Warwick,

Ausgrid welcomes the opportunity to comment on the Australian Energy Regulator's (AER) consultation paper on setting the pathway to the 2022 Rate of Return Instrument (2022 Instrument). We support the AER commencing the 2022 Instrument process early and amending the timetable to address some of the timing constraints that were faced during the 2018 Rate of Return Instrument (2018 Instrument).

Our short submission proposes a few key areas of improvement for the 2022 Instrument compared to the 2018 Instrument process. We have not answered the specific questions raised in the consultation document individually, but support the responses made in the Energy Networks Australia (ENA) submission.

We recognise the challenges faced by the AER in setting rates of return for distributors. The process for the 2018 Instrument was hampered by the legislative process running concurrently with the AER's consultation process. The fact that several steps in determining the 2018 Instrument were being conducted for the first time inevitably resulted in teething problems.

At the same time, the feedback captured in the Brattle Report<sup>1</sup> commissioned by the AER highlights opportunities for improvement when the AER conducts the 2022 Instrument process. In our view, the most critical element to the success of the process is that the AER demonstrate a balanced evaluation of all the evidence in reaching its conclusions. Suggested actions that could go towards improving this are:

- Setting out in advance which experts from the expert panel will be used for each subject matter component and why they have been selected for that element
- Setting out cross checks in advance and articulating how the AER will address non-conformance with the checks
- Indicating up front how the AER will take into account market conditions, market expectations and financability of the sector
- Include in the timetable an assessment of the outcomes of the 2018 Instrument in decisions made since its implementation.

These issues are discussed in further detail below.

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<sup>1</sup> The Brattle Group, *Stakeholder Feedback on the AER's Process for the 2018 Rate of Return Instrument*, 27 June 2019.

## Expert Panel

The Brattle Report outlined a perception that contributions from the experts were “cherry picked” in order to engineer a particular outcome.<sup>2</sup> To avoid this reoccurring for the 2022 Instrument, the AER could set out which experts are to be used and which component of rate of return they will be asked to offer insights on. An up-front explanation about why they have been selected for a particular component and not others would also be beneficial. A commitment to giving equal weighting to all expert opinions and their evidence would assist in alleviating concerns about the use of experts.

## Cross checks

During the 2018 Instrument process the AER set out cross checks to be used to test reasonableness. In some cases where the outcome didn't meet the threshold, stakeholders felt that the AER did not provide a reasonable explanation for disregarding the cross checks and proceeding with the decision.<sup>3</sup> Confidence in the process would be increased if the AER defined in its position paper the cross checks it intends to make, along with a clear procedure outlining how it will address non-conformity with the cross checks. For example, it was not until the final Explanatory Statement that the AER provided reasoning that compelled it to not give much weight to comparison with other regulators' equity risk premium (ERP) estimates.<sup>4</sup>

## Market expectations and financability

Another key concern for Ausgrid is the AER demonstrating how it will take into account the impact the decision will make on distributors' ability to fund network investment into the future. This is particularly relevant as distributors move towards shorter lived and potentially riskier assets, such as those to be used integrating DER on the network. Financial markets are experiencing a period of turbulence with government bond yields at historic lows. While the National Electricity Rules and National Gas Rules do not explicitly direct the AER to take market conditions into account in setting the 2022 Instrument, there is a link between the financability of distributors and the long term interests of consumers as established in the National Electricity Objective (NEO) and National Gas Objective (NGO). Successfully raising funds to invest in the reliability and innovation of networks is in the long term interests of consumers.

## Assessment of 2018 Instrument

It would also be helpful if the process included some assessment of the outcomes of the 2018 Instrument in decisions made since its implementation. This would help determine if the decisions have created any unintended consequences and may assist the AER to identify elements of the decision that require re-examination. For example, in Ausgrid's final regulatory determination for 2019/20 – 2023/24, the 2019/20 return on debt was higher than return on equity. This is a departure from conventional finance theory and the AER's correct expectation that it is “sensible for the return on equity to be higher than the return on debt”.<sup>5</sup>

## Annual updates

Ausgrid supports the AER publishing annual updates to the key parameters. The update published in December 2019 was useful and this initiative will help to keep all stakeholders informed of developments in markets that drive the parameters.

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<sup>2</sup> The Brattle Group, *Stakeholder Feedback on the AER's Process for the 2018 Rate of Return Instrument*, 27 June 2019, p18.

<sup>3</sup> The Brattle Group, *Stakeholder Feedback on the AER's Process for the 2018 Rate of Return Instrument*, 27 June 2019, p11.

<sup>4</sup> AER, *Rate of return instrument: Explanatory statement*, December 2018, p117.

<sup>5</sup> AER, *Issues paper: Review of the rate of return guidelines*, October 2017, p25.

If you have any queries in respect of this submission, please contact Fiona McAnally [REDACTED]  
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Yours sincerely

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