CRG RATE OF RETURN GUIDELINE REVIEW – DRAFT DECISION RESPONSE

Presentation to the AER Board, 5th October

OCTOBER 2018

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CRG ROR GUIDELINE REVIEW – DRAFT DECISION RESPONSE

The AER's review process:

- Is an incremental review. The CRG contends that a fundamental review, including the use of the CAPM, should be commenced as soon as the first binding instrument is made.
- We have actively participated in the review.
- Which has not stepped beyond the boundaries of being incremental.
- The draft decision delivers a balanced outcome

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May 2018 submission

- The CRG's May 2018 submission did not seek to arrive to arrive at definitive answers on each of the parameter settings, rather it encouraged the AER to take into account the perspectives and matters it raised and to exercise its judgement accordingly, and suggested:
- The AER should justify why it would choose parameter values other than those which delivered the lowest costs to consumers.

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The Draft Decision:

- Doesn't deliver a lot for consumers – the impact of a $40 (2.4%) reduction per year on the average retail residential bill (ACCC - $1,600) could have been ~$100 per year or more, applying the CRG's recommended parameter settings.
- Consumers will continue to bear the costs of previous over investments and overly generous allowances on rate of return, which were weighted towards addressing the risk of under investment, versus the risk of excessive returns and the resulting impact of excessive prices.

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The Draft Decision:

From our presentation to the August 2018 public forum:

- Is capable of acceptance but only if this decision is seen as the first step in a downward progression over time to correct the current overly generous (to networks) ROR allowance.
- Consumers are astounded that networks, the ENA, do not find the draft decision capable of acceptance.

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Draft Decision – consumer impacts and risks

- For some consumers, electricity is already unaffordable, with heating costs emerging as a critical, even life threatening, issue.
- Residential and business consumers will continue to face very real pressures from electricity prices which include greater than efficient costs.
- Businesses where energy costs are critical determinants of international competitiveness are particularly exposed.
- Current hardship and disconnection rates will remain, or increase as the effect of a lack of wages growth and fixed low incomes continues to bite.

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Draft Decision – consumer impacts and risks

- Self generation is an emerging viable alternative for many consumers, but not for vulnerable consumers. More self generation means even higher prices for vulnerable customers.
- Every component of the electricity cost price stack must be the absolute minimum representation of efficient costs and must be tackled vigorously.
- In shifting the pendulum back from a balance which errs in favour of investment, the CRG does not accept that service levels should fall. The challenge for networks is to deliver the same, or better, for less, and to address the current over-investment, which the CRG sees as eminently possible.

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CAPM parameter values

- The detailed issues flagged by the CRG were discussed at the August 2018 public forum.
- We have adjusted the parameter ranges suggested in our May 2018 submission to take on board the details and explanations provided in the AER's explanatory statement and new information that has come to light.
- The CRG submission highlights the need to use available market data appropriately, with adjustments where necessary, in developing the MRP, equity beta, gamma and credit rating

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Exercising judgement

- The AER's previous cautious approach (erring in favour of investment risk over price outcomes and risks to consumers) appears to continue.
- When exercising its judgement (balancing) in setting point values, the AER should not assume that the starting point (2013, or before) in any instance was correct.
- The draft decision settings deliver around a 5% reduction in network costs for consumers (or 2.4% on a residential retail electricity bill) – a total saving of $510 million pa compared to current settings against a regulated asset base of $95 billion.
- Adopting the proposed CRG parameter settings, the possible savings would be $1250 million pa – the "premium" associated with maintaining investor confidence to ensure adequate investment, paid for by consumers, is $740 million pa.

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Investment risk versus price

- The CRG has referred to the AER's approach which places greater emphasis on the risk of under investment versus the risks which flow from over investment and higher than necessary prices.
- Our submission pointed out that consumers (currently) have a greater concern about high prices than about reduced reliability.
- But also pointed out that the rate of return has little to do with reliability outcomes and that the Guideline is not a mechanism for trading-off reliability and cost/price.
- A willingness by consumers to accept a higher level of risk in respect of the ROR and the investment it is intended to promote in exchange for lower prices does not mean that consumers are prepared to trade off price against reliability.
- The CRG suggests that surveys asking consumers to comment on the price versus reliability trade off need to be treated with caution.

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Investment risk versus price

- Consumers are prepared to accept greater risk of decreased reliability.
- Some may be prepared to trade off reliability against price, others may not.
- The CRG expects that current reliability levels can be maintained or improved with a lower level of investment.
- That should be achieved by increasing the efficiency of investment, for example:
    - Avoiding premature investment in what would ultimately be productive investment (the current level of over-investment results in under-utilization - reducing investment and increasing utilization need not adversely impact reliability);
    - Using existing capital more efficiently (increasing capital productivity);
    - Avoiding expenditure which will not provide directly measurable benefits (gold plating); and
    - Greater investment in demand management.

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Broader review

- To be able to answer the all important question – “did we get it (the allowed rate of return) right?”
- A more comprehensive review of the ROR Guideline is required with the resulting process informed by actual earnings returns as evidenced via a rigorous reporting regime, with greater consumer input.
- This view was supported by a number of recommendations contained in the Independent Panel’s report.

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Thank you