CRG RATE OF RETURN GUIDELINE REVIEW – DRAFT DECISION RESPONSE

Presentation to the public forum,

2nd August 2018

AUGUST 2018

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The CRG:

Represents a diverse range of perspectives, including:

- Major energy users
- Small business
- Rural business
- Residential customers

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The AER's review process:

- Is an incremental review. The CRG was formed too late to express a view on the scope of the review, but 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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Our submission – re-cap:

- Risk reductions for network companies were not reflected in the 2013 Guideline.
- AER draws market data from companies with regulated and non regulated components – not representative of a regulated BEE.
- There is no data on actual returns against which to compare modelled returns - AER decisions are reinforced by the use of market data that themselves reflect previous decisions.
- The Black version of the CAPM and the DGM used in the Foundation model (2013 Guideline) result in an excessive allowance for the equity risk premium.

Correcting those flaws >> equity beta 0.2 to 0.5; gamma close to 1; MRP 3.6 to 4.76%

>> even assigning mid point values would still deliver retail bill reductions of around 7%.

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Engagement with ENA and IRG:

- Fortnightly meetings with the ENA leading up to the May submissions.
- CRG position – rate of return is too high and has been over an extended period.
- Details as per our submission.
- Limited time therefore no closure of the different perspectives on most elements of the RoR, but able to understand each other's rationale.
- One meeting with the IRG.
- Same messages, but emphasized the alignment between our interests – maintaining the value of the assets we have each invested in.

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Consumer perspective on rate of return:

- Consumers have a huge stake in ensuring the value of our investment in network assets is maintained – our interests are directly aligned with investors' interests, not opposed to them.
- We believe those interests have not been well served by years of excessive returns where the affordability issue, and the risks to consumers of excessive returns, have not been addressed. The draft decision continues that.
- The recent review by the ACCC points to the savings which consumers should be enjoying going forward:

Table A: Achievable average annual residential bill savings by 2020–21

		Achievable savings ($ per annum)						
Region	2017–18 Bill	Networks	Wholesale	Enviro	Retail	Reduction	2020–21 Bill	% Reduction
Victoria	1457	39	192	34	26	291	1166	20
NSW	1697	174	155	43	37	409	1288	24
South east Queensland	1703	147	192	18	62	419	1284	25
South Australia	1727	13	227	89	42	371	1356	21
Tasmania	1979	113	226	75	–	414	1490	21

For small business customers, similar savings can be made. However, as a larger proportion of small businesses are on standing offers, the recommendation to abolish the standing offer and implement the lower-priced default tariff will have a proportionately greater benefit to small business customers.

ACCC-Retail Electricity Pricing Inquiry:

- Up to $174 (NSW) can be saved per residential bill per year in network costs, around 42% of the total savings that the ACCC says is achievable.
- Includes asset write downs but not RoR outcomes.
- Consumers want to see those savings, plus RoR savings, actually happen.

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The draft decision:

- Doesn't deliver a lot for consumers – the impact of a $40 (2.5%) reduction per year on the average residential bill (ACCC - $1,600) could have been $140 per year or more.
- 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.
- Is capable of acceptance but only if this decision is seen as the first step in a downward progression over time.
- 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.
- Residential and business consumers will continue to face very real pressures from electricity prices which include greater than efficient costs.
- 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.
- 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.

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CAPM parameter values

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Equity beta:

- AER:
- Equity beta 0.6 – down from 0.7
- CRG:
- Questions why market data, with outcomes driven by past regulatory decisions, is used as a surrogate for the risks faced by networks. This aspect has to be addressed at the next review.
- There are now only three listed network firms which can be used to calculate equity beta.
- Based on the work by the AER in the draft decision, a reasonable setting for equity beta could be 0.4, yet the AER has only moved to 0.6
- The analysis undertaken by the AER reflects equity beta for listed network entities which have both regulated and unregulated assets – regulated assets would have a lower risk than unregulated assets and therefore a lower equity beta
- Adjusting for the proportions of regulated and unregulated assets in each firm's portfolio, the CRG assesses an average equity beta for regulated assets is 0.35 and unregulated assets 0.75.

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MRP:

AER:

- MRP 6.0% - down from 6.5%.
- HER range 5% to 6.5%. Less confident in DGM guidance.

CRG:

- The long term trend of ASX MRP is downward and currently at less than 6.0%
- The rewards for networks come from the RoR and also from: incentive schemes ; revenue from assets used for unregulated services; the premium between the allowed and actual cost of debt and the premium between allowed tax and actual tax.
- The ASX MRP incorporates the benefit from all of these sources. Adjusting for this, the CRG considers that MRP should be lower than the mid point of the range of MRP values.
- CRG considers that MRP is between 3.6% and 4.8%, rather than the AER's 6.0%

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Gamma:

The gamma challenge – "*estimating something that no-one agrees is the correct thing using bad data*" (Professor Gray, Expert Evidence Session 2).

AER:

- Estimate of 0.5, up from 0.4 – distribution rate of 0.88 and utilization rate of 0.6.
- Lally ASX top 20, "all equity".

CRG :

- Rather than an arbitrary, balancing process, adopt one based on objective criteria.
- Assume an efficiently financed entity providing regulated services - don't look at broad market data.
- Distribution rate close to1 - formula based.
- Utilization rate of 1 – Australian investors making use of imputation credits.
- >> Gamma close to 1

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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 2.5% on a retail bill). The CRG's analysis suggests that applying parameter values most favouring consumers would deliver bill reductions of around 9% - the draft decision delivers a penalty on consumers of around 6.5% or 1 billion pa on the equity component.
- Adopting a mid point of the CRG's parameter range, the penalty is around 4.5% or \$0.8 billion pa on the equity component.

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Broader review

The CRG notes that this review has raised further concerns about the use of the CAPM and we encourage the AER to undertake a more fundamental review of the approach to determining the allowed ROR as soon as the first binding instrument is made. This needs to include a performance evaluation framework.

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Thank you