17 August 2018

Ms Paula Conboy
Chair
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Ms Conboy,

AER Rate of Return Review Process – Draft Guideline

We are writing to you on behalf of electricity transmission and distribution networks and gas distribution networks to highlight our serious concerns with the draft Rate of Return guideline released by the Australian Energy Regulator on 10 July.

At the commencement of the guideline review process all members of Energy Networks Australia indicated that we want to play our part in delivering an outcome resulting in an affordable, secure and reliable energy future for Australia. We remain committed to this goal.

Rate of return guidelines that are effective and supported by all stakeholders will contribute to our capacity to do this by allowing for the efficient financing of long-lived infrastructure and energy solutions to meet the needs of almost 10 million Australian electricity customers and over 4 million gas customers.

There is no question high power prices are a major issue. As advised by the AER at your public forum on 2 August, rising prices are a significant concern for consumers in the context of this review.

We believe this community concern is genuine but seeking to target its resolution in the context of the rate of return guideline task facing the AER is misplaced. Network charges have been falling across the country over the last five years. In contrast, recent financial results showing a tripling of profits for both EnergyAustralia and AGL and a doubling of Origin Energy's underlying profit suggest that it is not network rates of return being too high that are contributing to ongoing price concerns.

Draft guideline is not capable of acceptance or in long-term interests of customers

Networks are unanimously of the view that the draft guideline, while delivering short-term price decreases, will not deliver outcomes that are in the best long-term interests of customers or be capable of acceptance by energy network businesses. This is largely because:

I. The draft guideline decision overlooks the lessons of the past two decades: that the long-term interests of both current and future consumers are best served by ensuring commercially sustainable returns on past and new investments; and

II. Networks are losing confidence in the review process, primarily due to the lack of a balanced assessment and treatment of expert and other evidence – particularly regarding the cost of equity and the departure from the AER's previously preferred position on gamma. This risks undermining confidence in the current review process and highlights our previously stated concerns regarding LMR abolition.

The past two decades: overreactions have harmed consumers

Over the past two decades, major decisions around network financing and investment have led to poor outcomes for consumers:

- Around the turn of the century, material under-investment in networks in New South Wales and Queensland was a factor in significant outages in both states in 2003/04.
- In response, unprecedented reliability standards were imposed in those states and major increases in capital expenditure occurred. These resulted in abnormal growth in network charges.
- In response, new regulatory rules were introduced and rates of return fell following the the AER's previous 2013 guideline. These changes were followed by large decreases in capital expenditure in some regions and network prices falling across the country over the last five years.

Decisions made in 2003/04 were based on the information available at that time and were drastic changes implemented to resolve short term issues. However, in hindsight it is clear that responses to the first two points above went too far and had consequences that were not in the long-term interests of consumers. Changes outlined in the third point have been and are continuing to deliver lower network cost outcomes for customers.

While consumers and their advocates may seek a significant reduction to the rate of return to achieve short-term price reduction, networks strongly urge the AER to avoid repeating the mistakes of the past and take a long-term view. We are concerned that the draft guideline goes too far once again and will be another drastic change that will hurt customers in the long term.

Our concern is also highlighted by the market context – the draft guideline proposes simultaneous changes to equity beta, market risk premium and gamma that all drive lower returns – but recent evidence shows that the market is moving in the opposite direction. This is most clearly evident in the case of equity beta.

Confidence in the review process and treatment of evidence

Networks have supported the AER position of undertaking an incremental review that is capable of acceptance, and have participated fully and constructively in the process to date. We welcomed and supported the proposed review process, which included many innovative and positive opportunities to approach this important review in a different manner than previously.

On the basis of the AER's process goal of a guideline that was capable of acceptance by all parties, and AER's statements that there had been no change in relevant finance theory, networks have taken a deliberate collective action of not re-agitating areas already decided (such as the foundation model approach). Similarly, networks have not provided detailed expert reports on each possible area given that significant changes in the AER's foundation model approach were not anticipated.

The proposed fundamental changes to the foundation model, and an effective reversion back to a purely mechanistic application of the Sharpe-Lintner CAPM approach has significantly undermined the confidence of network stakeholders in the robustness, integrity and transparency of this review process.

Network businesses' confidence in the process has been further undermined by a number of other aspects of the draft guideline. Most concerning is the rejection of agreed Joint Expert positions. The disregarding of a number of agreed positions set out in the Joint Expert Report prepared by the independent convener (on the basis that AER's own expert may have expressed some disagreement with that statement if the AER had allowed more time for them to consider it) does not appear reasonable nor reflect a balanced assessment of the evidence.

All network stakeholders accept that rate of return estimation involves areas of judgement and discretion on which reasonable minds can differ. This very fact makes instances in which the AER draft guideline decision is, without compelling contrary evidence, at variance with the findings of an approved Joint Expert report incompatible with stakeholder expectations of a sound evidence-based process.

Energy Networks Australia's presentation to the AER public forum on 2 August outlined more of our concerns in this regard.

Inadequate analysis of long-term interest of current and future consumers

Energy network businesses are concerned that these far-reaching proposals have been made without a comprehensive analysis of implications for both current and future consumers. If the draft is unchanged, the outcome will be largest ever single reduction in return on equity (around $400 million per year on an industry basis). Such an outcome would be expected to trigger aggressive re-evaluation by network owners of investment processes and decisions with flow on long-term implications for services to customers.

The draft guideline's equity risk premium of 3.6 per cent would be below recent decisions and estimates applying across similar energy infrastructure in United Kingdom, New Zealand and the United States. Such a low rate will have an unfavourable impact on the investment environment. It will certainly impact on credit metrics for network businesses which could trigger rating re-evaluations and higher debt costs, which would only lead to cost increases for consumers in the long run. It would be concerning if Australian investors were best served by investing in the transition to the sustainable energy futures of other countries in preference to their own.

It is not clear that the AER has undertaken any assessment or analysis of the potential long-term consequences for customers of these likely outcomes.

Next steps – ways forward to re-establish confidence in review process

The network sector is looking to the AER Board in its final guideline decision to actively demonstrate to network stakeholders that its decision is appropriately responding to movements in relevant evidence. While it is clear the draft guideline delivers on short-term price outcome objectives, we do not believe it is in the long-term interests of consumers, and indeed long-term cost minimisation.

As Chair and Deputy Chair of Energy Networks Australia we wish to emphasise that all electricity transmission and distribution networks and gas distribution networks want to play our part in delivering an affordable, secure and reliable energy future for Australia. We remain committed to continuing our open and constructive engagement with all stakeholders throughout the process.

To advance our shared objective of a guideline that is capable of acceptance by all stakeholders and re-establish confidence in the AER review process we make the following practical suggestions:

1. **Provision of presentations to Independent Panel -** Full presentations from all stakeholders represented at the AER Public Forum be provided to the Independent Panel charged with reviewing the draft guideline. This will ensure significant stakeholder perspectives on the draft guideline are considered by the Panel and increase stakeholders' confidence in the robustness of the process.
2. **Final guideline to include risk and impact assessment of changed approach** - The final guideline should reflect a sound evidence-based decision and include a full risk analysis of the potential outcomes (and long-term costs) for future consumers of the recommended approach. This risk analysis should include a financeability analysis to ensure that credit metrics for benchmark entities do not fall to unacceptable levels.

Please feel free to contact us or Energy Networks Australia CEO Andrew Dillon at any time through the review process should there be any issues you would like to discuss, including in relation to our contribution to your review process.

Yours sincerely,

[redacted]

Nino Ficca

Chair, Energy Networks Australia

[redacted]

Tim Rourke

Deputy Chair, Energy Networks Australia