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Mr [redacted]
General Manager Networks Finance and Reporting
Australian Energy Regulator
GPO Box 520 Melbourne Vic 3001

By email to: [redacted]

Return on Debt

Dear [redacted]

Energy Consumers Australia appreciates the opportunity to comment on the Australian Energy Regulator's (AER) *Rate of return; Energy network debt data - Draft working paper* (the Paper) of June 2020.

Energy Consumers Australia is the national voice for residential and small business energy consumers. Established by the then Council of Australian Governments (COAG) Energy Council in 2015, our objective is to promote the long-term interests of energy consumers with respect to price, quality, reliability, safety and security of supply.

The AER is now engaged in developing the second Rate of Return Instrument, which is also the first time where the development has begun under the new legislative provisions that created a binding instrument to replace the earlier guideline. We greatly appreciate the effort the AER has taken to commence the review early and the commitment to developing a series of working papers as part of that process. This early preparation includes the formation of the Consumer Reference Group (CRG).

In this submission we will first expand on the evidence of consumer priorities and then discuss the significance of the early creation of the CRG and how that should inform the AER's early work. We conclude with some brief comments about the Paper.

What consumers are telling us

Our research on consumer preferences and expectations through the Energy Consumer Sentiment Survey (ECSS)[1] and the Consumer Expectations Research[2] reveals that consumers' highest priority remains affordability and the area of least satisfaction is current value for money. At the same time consumers expectation is that in the future energy services are simple and easy to manage.

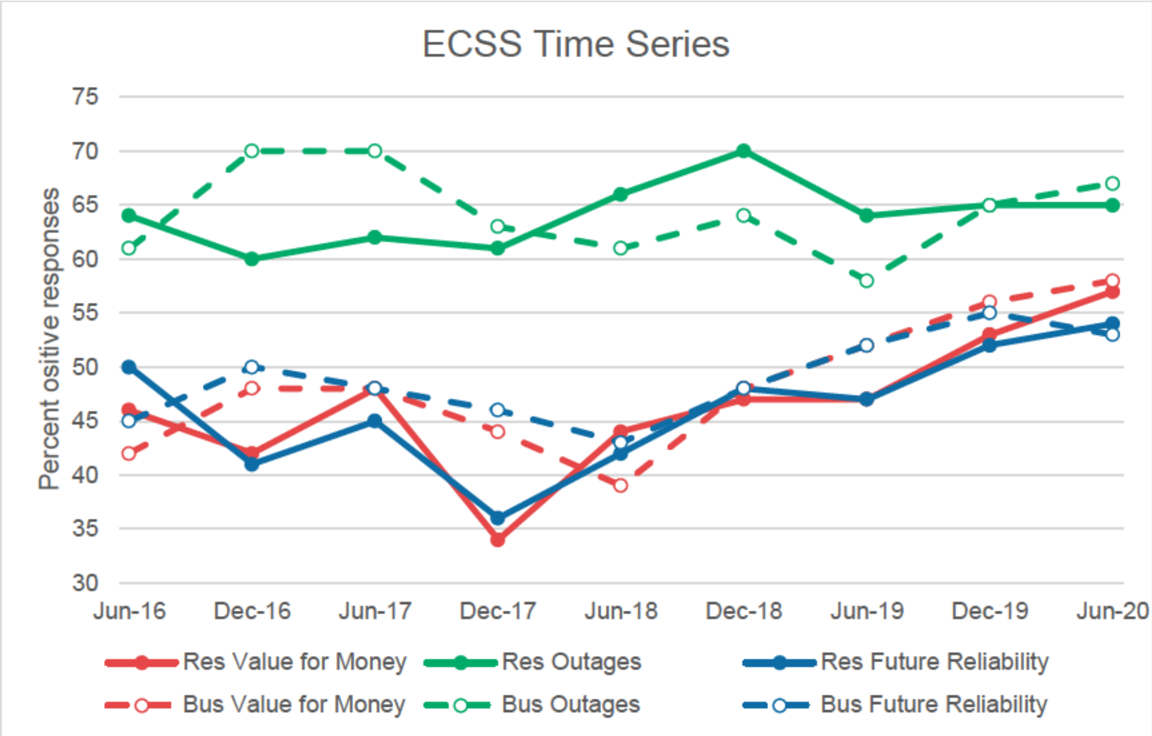
Figure 1 below shows the proportion of electricity consumers providing a positive response (% 7 or higher out of 10) by household and business consumers to three questions:

- Value for Money "How would you rate the overall value for money of the products and services provided by your electricity company in the last 6 months?"
- Outages "Thinking about the reliability of your electricity supply, how satisfied are you with the number of times you've had loss of power, blackouts or other faults with your electricity supply in the past 6 months?"

[1] https://energyconsumersaustralia.com.au/projects/consumer-sentiment-survey
[2] https://energyconsumersaustralia.com.au/wp-content/uploads/Future-Energy-Vision-Forethought-Household-Full-Report.pdf and https://energyconsumersaustralia.com.au/wp-content/uploads/Future-Energy-Vision-Forethought-SME-Report.pdf

- Future Reliability “How confident do you feel that the energy market will provide better outcomes for you in 5 years, in terms of reliability of power supply? By ‘market’ we mean the energy industry and energy regulators.”

Figure 1: Selected ECSS time series data

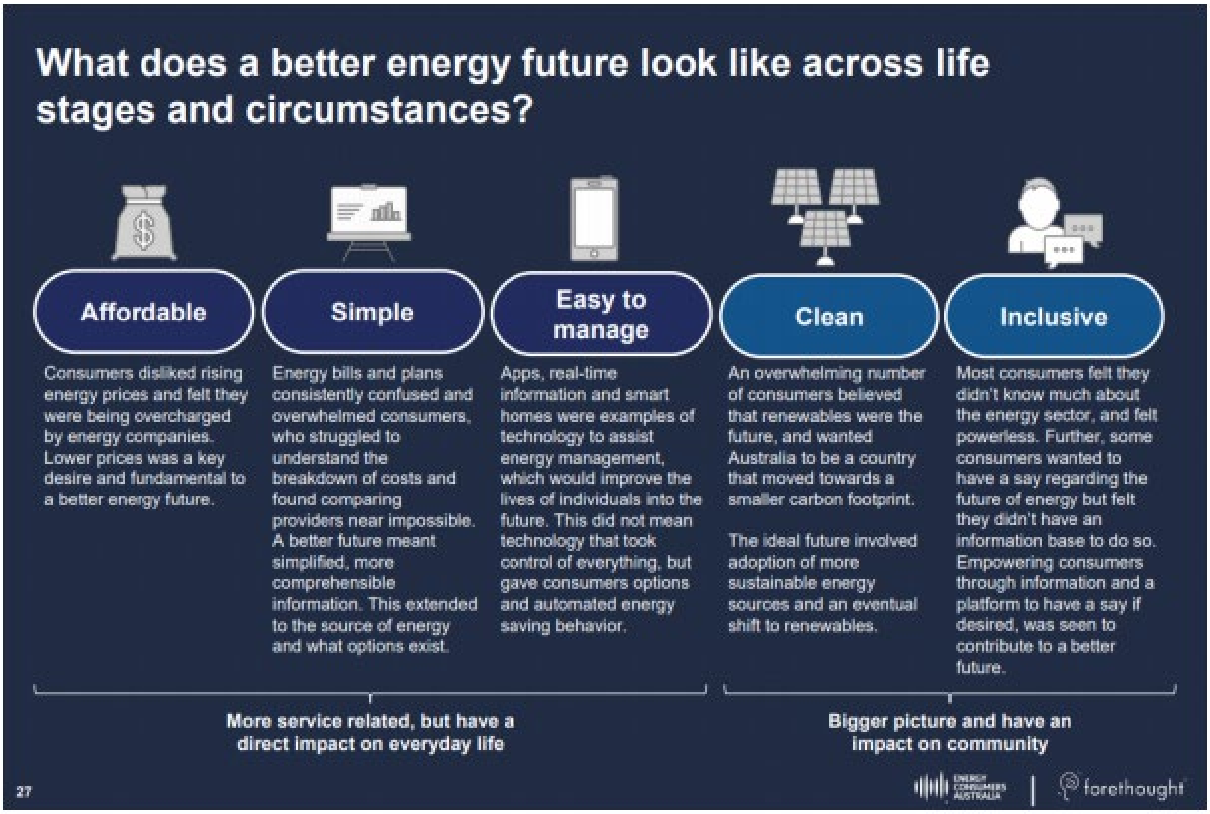


The responses show that household and business consumers have been more satisfied with current reliability than with value for money, though the gap is closing. Consumers have less confidence about future reliability though it intriguingly is closely correlated to value for money rather than current reliability.

The Consumer Expectations Research provides a wealth of information about consumers’ experience of energy. It found that household consumers were focused on their everyday lives and often had so much happening, that energy was not top of mind, except at points of transitions in their life, including moving to a new house, starting a family, retirement. At these transition points, the experiences were often negative, and consumers asked themselves “what’s the point” of doing more to understand how to engage with the retail energy market. Similarly, small businesses felt stuck on how to change their experience for the better but were acutely focused on the opportunity cost of energy in reducing their profitability or reducing the number of their employees.

In addressing the fundamental question of what better looks like, the Consumer Expectations Research revealed that households have five objectives from the future energy system, shown in Figure 2.

Figure 2: Consumer vision for the future retail energy market



Through this research energy consumers are telling us, regulators and policy makers that they are still more concerned about price than reliability. They are also telling us all that they want to be heard about the future of the energy system. We believe regulators and policy makers need to reflect this concern in their decision making. In the Rate of Return Instrument Explanatory Statement of December 2018 the AER observed (P.413)[3]:

> *We accept submissions from consumers that they prefer not to see a reduction in reliability and service standards and a higher risk of outages. However, the CRG goes on to submit that consumers are willing to accept the risk of lower rate of return because they consider the consequential risk to network performance is low. In reaching this view, the CRG cites flat demand, excess capacity and good current levels of performance by networks. It considers that even if investment is below ideal levels there is unlikely to be an immediate impact on network performance. We cautiously accept this submission.*

Until such time as there is further additional research this position should continue to be the basis of the AER's decision making.

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[3] https://www.aer.gov.au/system/files/Rate%20of%20Return%20Instrument%20-%20Explanatory%20Statement.pdf

The Consumer Reference Group

As noted in the quote above this position was advanced in the last review by the CRG. For the 2022 instrument the CRG has been strengthened by being appointed earlier, and with greater initial AER support. ECA has a position on the CRG. Further ECA has committed to provide research support to the CRG.

In general, it is ECA's expectation that we will not be duplicating the work of the CRG in making submissions on all processes through the current review, although we may make our own submission if our expertise warrants it.

The ability of the CRG to respond to consultations will be facilitated by the AER discussing draft position papers or consultation papers with the CRG as they are being developed. This use of the CRG is appropriate as it is the only consultation body required by legislation and that part of the rationale for the CRG is that there is a significant imbalance between consumers and networks in both their ability and motivation to participate in detailed regulatory reviews.

Comments on the Paper

There is no doubt that the *Energy Infrastructure Credit Spread Index* (EICSI) is providing valuable insights into the actual cost of debt facing the regulated businesses, nor is there any doubt that it should continue to be developed by the AER. There are two sets of questions posed about the EICSI – how it should be used and whether it should be further developed.

Before we turn to that there are some fundamental points about the whole rate of return question that need to be acknowledged. The first is that the three core parameters in a 'weighted average cost of capital' (WACC) are interdependent. The rate of return on both debt and equity is dependent upon the gearing ratio. A bank would charge a higher interest rate depending upon how much the finances of the company are dependent on debt, and the whole reason for pursuing debt financing is to reduce the overall cost of capital and hence boosting the return to equity holders.

The ultimate question is how the treasury function of a regulated business manages the business's capital structure. The evidence from the EICSI seems to be that stability of the spread of cost of debt and the risk-free rate is either a goal of treasurers or is a natural consequence of that goal.

This provides a potential answer to the first question of how to use the EICSI. If the objective of treasurers either is, or at least results in, a stable spread then it is logical for the regulatory process to adopt that spread as the means of determining the return on debt.

The danger with this approach is that treasurers knowing the link between the EICSI and allowed rates might change their behaviour from promoting stability to promoting volatility as a device to periodically procure higher allowed returns. Therefore, if the EICSI is used to set the return on debt it should be used to select a single number for the spread which will be applied for an extended period. If the AER considers the use of a single pre-determined spread for the determination of the return on debt the same approach should be considered for the return on equity.

Notwithstanding this more speculative use of the EICSI, if it is used in any of the other proposed ways – ranging from simply using it as a test of reasonableness through to adding the EISCI as another series from which the return on debt is drawn. For all these applications we agree with the AER that there is little advantage in any of the proposals for further EICSI development.

Conclusion

We commend the AER on its approach to date for the development of the 2022 Rate of Return Instrument. We support the use of the EICSI in the determination of the return on debt and look forward to the AERs further consideration on the matter. We encourage you to utilise the CRG extensively in this development.

Should you have any questions about our comments in this submission, or require further detail, please contact [redacted] Acting Director, by phone on [redacted] or by email at [redacted]u.

Yours sincerely,

[redacted]

[redacted]
Chief Executive Officer (Interim)
Energy Consumers Australia