Submission to the Australian Energy Regulator

In response to the Draft AER's Rate of Return Instrument

From: Mark Matheson – a consumer.
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Intoduction

The submission responds to the draft determination of the AER for the Rate of Return Instrument 2022. All comments are in consideration of the potential impact on consumers connected to the NEM as retail residential customers.

Viewed from the view point of an average residential consumer the draft RORI is a complex document. It requires a degree of blind trust by the residential consumer that the process followed, assumptions and judgements deliver outcomes that meet the current expectations of residential consumers.

Consumer expectations and needs do change.

A concern is whether the assumptions used in delivering the draft RORI align with the expectations of the average residential consumer. The AER has exercised judgement in delivering the determinations. These are aligned to the needs of the distributors, through the estimated rates of return on equity and debt.

The AER explains in its explanatory note setting the rates of return to be like what happens 'when a person buys a house'. It is not necessarily a reliable analogy. The AER may find it is more meaningful or appropriate to use "when an investor purchases a property'. A property investor is exposed to taxation requirements/benefits. There is commonly an expected benefit from property of longer term capital gains, accelerated through economic growth (inflation). Similar applies to an investor in a distribution network. Over time there are assumptions about the capital value of a well maintained asset increasing. There is potential for investors to see growth of income over time without any increased equity due to the effects of inflation. There are additionally opportunities for income growth from increased consumption per customer and growth through expansion of the asset base or numbers of connected customers. All serve to increase the value returned to investors over time relative to the direct (committed equity) cost of the initial investment.

It's commonly related to the average consumer one if not the greater benefit of property investment is capital growth. A second benefit is someone else is paying off your debt and your equity is increasing without the investor increasing their contributions. It appeared to be a complex discussion in workshops facilitated by the CRG. The RORI does not reference an assessment of benefit to the distributors derived from growth of the asset or increases in consumption across the existing asset base. There is an assumed value in the AER's RORI supporting documents the equity to debt ratio is an approximately 40/60 split. There is also determination of a value for the RAB for each distributor. As a consumer the perception is the increase in the value of the owner's equity over time is being funded by the income from operation of the network. This comes at the expense of the consumer. It's how it works with an investment rental property, hence to an average residential consumer also how it must be for the now mostly unlisted distributors.

It is a significant question. There is cause for consumer concern as to how effectively the RORI determinations represent the financial impacts and needs of consumers or preference investors. Judgements of the AER in delivering a greater return to a distributor, increase consumer concerns the RORI is not fairly meeting consumer concerns.

Observations on Investor Behaviour

It's noted that there have been recent changes in ownership within two of the larger distribution networks. Have the transfers been at a profit or gain to the seller? A question a residential consumer might ask is whether any premium or loss compared to the RAB is used in the determination by the AER for the RORI? There is a further question whether any assessment of capital gain should be relative to the original equity commitment by the seller? If the sale has been at a premium, has the seller derived an additional unfair benefit? IE have prior RORI determinations been adjudged too high? If the purchaser has paid a premium, does the average residential consumer see this as indicative the determined rate of return has been set too high?

Considering the AER in setting the ROR, as not to high and not too low, has the AER delivered an outcome that ensures investors in the distribution networks are discouraged from exchanging equity for a premium? In any instance where there is a purchase premium, what is assessed and where is the benefit to the cost of distribution passed to the consumer? An uninformed consumer view is several of the ownership changes have delivered a positive return in addition to any returns delivered through the RORI.
note: In considering the long term benefits to consumers it would be appropriate to have confidence that network ownership does not become a tradeable commodity. One for which new owners continually have increasingly greater expectations of capital gain and returns on equity funded by the consumer's purchases.

Complexity and Conflict

The financial analysis by the AER in support of the RORI is detailed and complex. The supporting documents and advice is substantial. Reference to the various regulatory statements and documentation provides a wealth of detail on how the RORI delivers a satisfactory outcome to the distributors. The presented financial analysis viewed as a consumer delivers assurances of profitability to the distributors. The underlying principles are based on encouraging investment against a theoretical competitive market. Investors can choose to participate as an owner of NEM distribution network assets of look elsewhere.

There is little in the content to suggest the specific circumstances of residential consumers have been directly considered. Although daily consumers also make financial decisions based on economic needs. It appears a lopsided assessment. In exercising judgment the AER does not present an equally complete or compelling analysis of the consumer circumstance. Without quantifying the direct impact of the RORI on the consumer the AER has no way of demonstrating the decision is one that is balanced against consumer need. There is no technical or financial demonstration of the outcomes of setting lower rates of return for the distributors. Without the analysis or support for setting a lower ROR's a consumer might view any determination a guess rather than a judgement. Others may suggest it as an outcome biased towards the distributors. Hopefully there is more in support of how the AER has measured the impacts on consumers.

For residential consumers the current economic circumstances offer no assurances. The impacts on the average consumer of inflation are most often related to measures of CPI.

The AER proposes a return on the equity of 6.5% up to 6.8%. Most consumers would consider this return from a secure investment such as the energy supply networks as several times what they could earn from any other low risk investment. Residential property investment returns are at best 5% before deductions and tax adjustments.

In simple consumer language the rate of return on equity proposed by the AER is greater than the rate at which wages and incomes are forecast to increase. I'd ask the AER to reconsider this given the return on debt is linked to the cost of finance. The distributors have a degree of protection against changes in the cost of finance. There is an opportunity for the AER to reduce for the financial stress the draft RORI will have on the average consumer if it does not reconsider and reduce the high rate of return on equity?

A very Residential Consumer Perspective.

As a residential consumer everyday decisions are made using some easily communicated principles.

1. Is the service or product I'm about to pay for affordable?
2. Is the service or product value for money?
3. Is there an alternative point of purchase?
4. Can I use less or find an alternative and do away with the product?

When I look to the AER draft RORI it's not evident how or even if the judgement exercised considers how a typical residential consumer views the purchase of energy. The expressions used in the RORI determination are not relatable in terms the average consumer is familiar with.

For most products other than electricity and gas supply there is competitive tension. If a product is too expensive consumers may choose to do without, to substitute, to go elsewhere for a better price.

The draft RORI proposes to consumers that the distributors will over the life of the determination assure the distributors of a substantial margin. The greater margin delivered by the RORI the more distribution costs will contribute to residential consumers household costs. The impact looking to current economic forecasts is an environment of increasing consumer costs (CPI – inflation). Concurrently wage and pay increases have lagged CPI. The RBA has taken measures to raise interest rates that also lead to increased cost pressures.

As an everyday investor one reality is investment in capital assets is a long term decision. When the market (consumer) is under pressure financially business decreases. As a business there is an option to reduce costs and spending. The return to the shareholders /owners is also reduced. Where there is an need to commit to new capital expenditure financing of these decisions can come through a number of sources. These can include capital reserves (savings), borrowing (finance), or shareholders (increasing equity). The funds are committed against future gains in value of the asset as well as being able to deliver future income. The investors have discretion as to which resources they call on. Should the cost be added concurrently to those felt by the consumer?

As a consumer I see the RORI assuring distributors of a return regardless of the economic circumstances facing their customers. There is no evidence of shared pain.

End Point

It's a long pathway for the average residential consumer to consider whether their best interests are being met by a higher rather than lower determination of the allowable rates of return. It's contended the average consumer should not accept the current draft determination. It does not take into account the capacity of the residential consumer to support increased returns to the distributors investors when wages and incomes have not at least kept up with CPI. In the instance of the indicative figures provided in the draft RORI, these are likely greater than CPI for the term of the 2022 instrument. This will only increase stress on residential consumers from the costs of electricity.

End of Submission