SACOSS
South Australian Council of Social Service

Marjorie Black House
47 King William Road
Unley SA 5061

P. 08 8305 4222
F. 08 8272 9500
E. sacoss@sacoss.org.au
www.sacoss.org.au

ABN 93 197 662 296

1 September 2021

Mr Warwick Anderson
General Manager, Network Pricing
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Lodged online: RateOfReturn@aer.gov.au

Dear Mr Anderson,

RE: AER Consultation on the Rate of Return – Omnibus Papers

The South Australian Council of Social Service (SACOSS) is the peak body for non-government health and community services in South Australia with a mission to advocate for the interests of vulnerable and disadvantaged people across the state. We thank the Australian Energy Regulator (AER) for the opportunity to provide feedback on its three draft working papers on *Overall rate of return, Equity* and *Debt* (the Omnibus Papers), published on 15 July 2021.

Introduction

SACOSS wishes to raise three issues in relation to the consultation on the Omnibus Papers. The first is an overarching concern that the AER should, but does not, take into consideration the broader social and economic impacts of its determination. In particular, the rates of return envisaged in the Instrument will increase income and wealth inequality which is not in the long-term interests of consumers (either as required by the Act, or otherwise).

Beyond that overarching concern, SACOSS wishes to address two issues arising directly from the AER consultation, namely:

- The low interest rate environment
- The dividend growth model

Socio-economic factors, Inequality and the Rate of Return

In a recent submission to a South Australian Parliamentary Committee, SACOSS provided a preliminary analysis of the impact on inequality of the rate of return on investment in the electricity network in South Australia. In doing this, we adapted the work of internationally renowned economist Thomas Piketty who posits that where the rate of return on capital (r) is greater than the growth rate of the economy (g), then (all other things being equal) it will result in greater inequality. As Piketty notes, this relationship of r > g is simply an accounting equation. Indeed, it is really just common sense in that if a part of anything grows quicker

than the whole, then the other part(s) must grow less quickly and the faster-growing part becomes relatively bigger.

This inequality arising out of r > g refers initially to the balance between capital and labour, but translates into income and wealth inequality in the community because the ownership of capital is disproportionately held by the top 10 percent, and in particularly by the top 1% and 0.5% of households. Accordingly, a relative increase in the rate of return to capital increases the share of income going to those holding that wealth.

Against this background, the SACOSS submission to the SA Parliament argued that, whether measured by the nominal-vanilla WACC (6.17%), the post-tax real WACC (around 3%) or simply returns to shareholders (5% - 6.2%), the rate of return to SAPN exceeded the economic growth rate and therefore would have contributed to increased inequality. This analysis only related to one regulated entity and was time-limited to the 2015-20 regulatory determination. However, the principle and indeed the rate of return now applying across the industry and envisaged as a result of the 2022 Instrument raise the same concerns.

Put at its simplest, SACOSS is concerned that the AER is setting a rate of return which contributes to increasing inequality in society and that, based on the public consultations to date, the impact on inequality is not considered in the rate setting. **The impact on inequality needs to be considered as part of the determination and factored in to a lower rate of return.**

In raising this concern, we of course anticipate an objection that such concerns are outside the ambit of the AER and the considerations mandated by the National Electricity Law. Section 7 of the NEL states that

> *The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long-term interests of consumers of electricity with respect to—*
> *(a) price, quality, safety, reliability and security of supply of electricity; and*
> *(b) the reliability, safety and security of the national electricity system.*

This would appear to be a narrow construction of consumers and their interests (theoretical consumers devoid of any social context), but even here it is not clear that consideration of price and safety should be so narrowly defined. As SACOSS has argued elsewhere, energy affordability is a product of price per unit, usage and income and that concern over price is really only triggered when affordability becomes an issue (consider for example, there is no concern over the price of a box of matches – even it were to double). Or put another way, the consumer interest is in the relative price of electricity – price relative to usage and income. There is no definition of price in the Act to mandate an exclusive focus on unit prices rather than relative pricing (and increasing inequality would impact on relative pricing for low income households).

Further, in key literature on social inequality which pre-dates Piketty, Richard Wilkinson and Kate Pickett, present evidence that inequality makes everyone in society worse-off. Accordingly, countries like Australia raise taxes and spend enormous amounts of money in social security and the provision of services to limit the impact of inequality – an

expenditure which is external to the energy market but significant enough to bring into question any analysis of the "efficiency" which does not incorporate such externalities. Indeed, the particular view of what constitutes efficiency in this context and the delineation of such costs as externalities is a view of one school of economics. That view is challenged by more heterodox economics, and is not one explicitly mandated by the Act.

Similar arguments of interpretation could be made in relation to climate change and safety: an energy system which contributes to a threat like climate change is clearly not "safe", and the "externalities" are crucial to the long-term interests (survival) of consumers.

Much of the corporate world has long accepted that businesses and consumers don't operate in the vacuum of economic theory supposedly required by the narrow reading of the AER mandate. The rise of the Corporate Social Responsibility acknowledges and aims to address these broader social impacts as part of market operations, and it would be a travesty if the AER was working in a narrower framework. However, if, or to the extent that the National Electricity Law does prevent consideration of the social outcomes of AER determinations, then legislative change is clearly required and the AER should recommend such changes to the Energy Ministers.

The Low Interest Rate Environment

Question 13 of the AER's *Overall Rate of Return Draft Working Paper* seeks stakeholder feedback on the potential use of financeability metrics as a cross check on the overall rate of return, asking:[1]

> *How can financeability metrics be used as a possible cross check to inform the overall rate of return?*

We oppose the view of network businesses that the low interest rate environment supports the need for the introduction of a 'financeability' test in any form (even as a cross-check measure), and strongly agree with the submissions of the AER Consumer Reference Group[2] that the primary responsibility for financeability lies with the regulated networks.

Energy affordability continues to be a primary concern for South Australian energy consumers, particularly low-income consumers. The AER's recent *State of the Energy Market Report*[3] shows that while South Australia has the second lowest electricity use in the NEM, electricity prices were 16–49% higher than other NEM regions. Importantly, low-income households in SA spent around 5.5% of household income on energy bills, this is the highest electricity bill to income ratio in low income households in the NEM, after Tasmania (see Figure 6.13, below).[4] Network costs currently represent 46% of a residential electricity bill in SA, a significant proportion of the highest average energy bill in the NEM (see Figure 6.8, below).

---

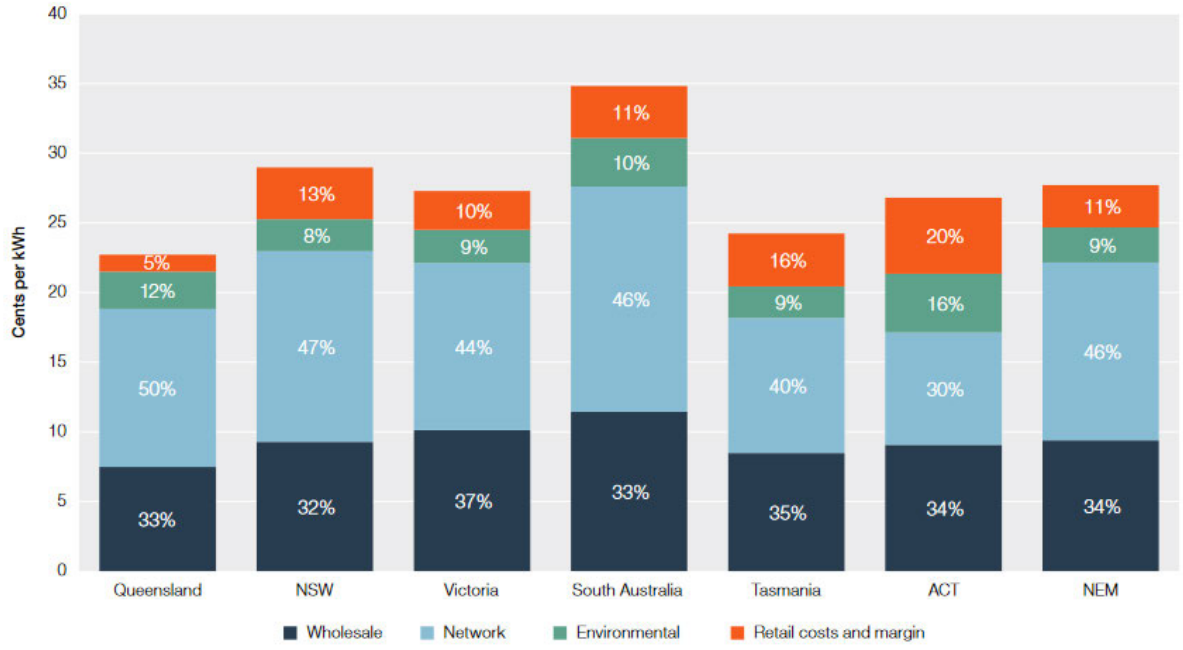
[1] AER, Overall Rate of Return Draft Working Paper July 2021, p.58

[2] AER Consumer Reference Group, Advice to the Australian Energy Regulator on the Rate of Return and Cashflows in a Low Interest Rate Environment, 2 July 2021, pp. 2-4

[3] AER, State of the Energy Market 2021, June 2021, p. 275

[4] AER, State of the Energy Market 2021, June 2021, p. 274

Figure 6.8 Composition of a residential electricity bill

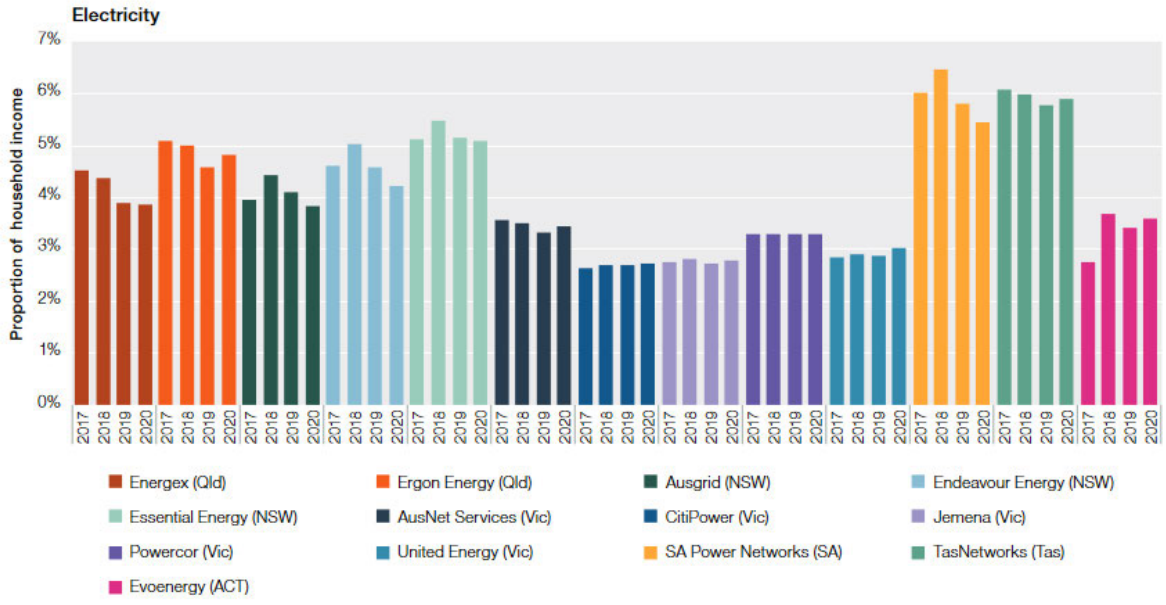


kWh: kilowatt hour.

Note: Data are estimates for 2020–21. Average residential customer prices excluding GST. Percentages may not add to 100% due to rounding.

Source: AEMC, *Residential electricity price trends 2020*, Final report, December 2020.

Figure 6.13 Energy bill burden on low income households



Against this background, SACOSS is very concerned about the impact of rate of return calculations on the price and affordability of electricity and we submit that no evidence of long-term consumer benefit has been provided to support any undermining of the stability of the AER's current approach to establishing the rate of return. Network businesses have not provided any 'real world' evidence to support their claims that services will decline if the rate of return does not increase, and as the evidence referred to in relation to our overarching argument suggests, their returns on capital are higher than returns to other economic factors in the economy. The arguments in support of adopting an inherently

unreliable test do not align with long-term benefits to consumers, particularly with respect to price, as required by the NEO.

The Dividend Growth Model

SACOSS strongly opposes the proposed use of the Dividend Growth Model to draw a relationship between the market risk premium and the risk-free rate. We agree with the Consumer Reference Group's preliminary response[5] that there is no relationship between those two parameters, and the DGM should not be used. Table below[6] shows that using the DGM would result in much higher and more variable estimates and no adequate reason has been provided to support adopting what is a fundamental change to AER methodology. Such a change should not be undertaken lightly as it opens up new questions of the reliability or viability of economic assumptions and modelling issues once the role of the ten-year government bond rate in setting the risk-free rate is neutralised.

HER = Historical Excess Return
DGM = Dividend Growth Model

Method	2018	2019	2020
HER – Arithmetic mean	6.0 – 6.6	5.8 – 6.4	6.0 – 6.5
HER – Geometric mean* ** excluding 1883-2017 estimates*	4.2 – 4.6	4.1 – 4.3	4.2 –4.5
HER – Geometric mean** *** all estimated ranges*	4.2 – 5.0	4.1 – 4.9	4.2 –4.9
DGM	5.96 – 8.59	6.42 – 9.83	7.07 – 10.79

← DGM estimates much higher & much more variable

** The HER geometric estimates for the longest estimation period (1883-2017) are consistently outliers*

Source: AER (2020) *Rate of return, Annual Update*, December. pp.14-15

Accordingly, for reasons of price impact, and the stability and legitimacy of the regulatory system, we do not believe that the proposed use of the Dividend Growth Model is in the best long interests of consumers.

If you have any questions in relation to this submission, please contact Georgina Morris at [redacted] or [redacted].

Yours sincerely,

[redacted]

Dr Catherine Earl
Director of Policy and Advocacy
South Australian Council of Social Service

[5] AER Consumer Reference Group, Equity Omnibus Draft Working Paper Preliminary Response, 11 August 2021

[6] AER Consumer Reference Group, Equity Omnibus Draft Working Paper Preliminary Response, 11 August 2021, p.12