AUSTRALIAN
ENERGY
COUNCIL

2 September 2022

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

Submitted electronically: rateofreturn@aer.gov.au

Dear Warwick,

Consultation: Draft Rate of Return Instrument 2022

The Australian Energy Council (AEC) is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. Our members collectively generate the overwhelming majority of electricity in Australia, sell gas and electricity to millions of homes and businesses, and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 percent emissions reduction target by 2035 and is part of the Australian Climate Roundtable promoting climate ambition.

A consistent and coherent approach to the rate of return framework

Retailers are acutely aware of cost of living pressures on consumers, which in concert with increases in bad debt from the COVID response are unlikely to be readily alleviated given the challenging and changing economic outlook. Retailers are doing their best, but network costs are costs that retailers can neither avoid nor directly influence at scale, and retailers and consumers are relying upon the AER doing an important job.

To maintain a consistent and coherent approach there should remain a "high bar to change", the approach supported by the AEC as well as by the AER's Customer Reference Group. The AEC also supports the view of the Expert Panel that overall, there appears to be nothing contained in the draft Rate of Return Instrument, nor in the AER's own analysis, that would suggest it is inconsistent with achievement of the NGO and NEO.[1]

Matching the length of the of the regulatory period to the cost of equity

The AEC notes the Expert Panel observations that investors will likely consider that there is a risk that the reset will not in fact replicate the cost of capital that will be faced over future regulatory periods[2]. However, the Panel subsequently, and in the AEC's view correctly, notes that it is not obvious that a 10-year term for the cost of equity addresses this risk either. The AEC agrees with the AER opinion that using a 10-year term is likely to lead to a biased outcome because the task is to set an efficient return *for the next regulatory period* [3](emphasis added). The AEC supports the

[1] Independent Panel Report, AER Draft Rate of Return Instrument, P.24.
[2] Ibid, P. 35
[3] AER Explanatory Statement, June 2022, P.32

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AER draft approach based upon this reasoning. Using a term matching the regulatory period seems a reasonable approach.

The AEC also notes the Expert Panels further concerns that the supplier nominated periods are to be confidential, and whether there is scope in that for suppliers to "game" this process[4], and we would like to see this matter expanded upon by the AER.

An expanded role for the Dividend Growth Model in the Market Risk Premium

The AER draft approach to set the MRP based on estimates of historical excess returns maintain our current approach is consistent with the 2018 Instrument, and a consistent and coherent approach to the rate of return framework. The AER notes in its draft that the MRP estimate has increased materially under the historical excess return (HER) estimation methodology used in making the 2018 Rate of Return Instrument due, and this was due to relatively high equity returns post 2017. The AEC shares the AER view that using HER does not mean an MRP estimate is backward-looking. As the AER note, HER is commonly used by both regulators and market practitioners to inform their estimates of the MRP within a forward-looking rate of return. The AEC supports the setting of the MRP based on the HER, consistent with the AER's past practice and with the principle of providing a consistent framework.

This does not mean to say that the HER method is perfect. But as noted by the CRG, there is an absence of empirical evidence that the prevailing approach has had a detrimental impact[5], and in the AEC's view this is a valid an assessment. The CRG has further stated that the HER method is the most appropriate for *long-lived assets with long-term investors* (emphasis added). Whilst an academic or theoretical case can be made for greater weight to other information in determining the MRP, there is no compelling case made that there is a problem with the current method that must be addressed.

NEO, NGO and the long-term interests of consumers

As the Independent Panel Report reckons, the fact that eight regulated network companies have been acquired by private investors since 2006 from a process that typically involves a premium for control, provides market-based evidence that the revenue streams offered by regulated network businesses are attractive to investors.[6] According to the AER 2022 report, network businesses achieved returns on regulated equity which exceeded forecast returns on equity by approximately 4.2 percentage points on average,[7] suggesting that the AER has consistently and materially erred in favour of networks and against customers. Whilst the AEC is not universally convinced that the AER's approaches will always promotes the most efficient use of network assets, nor that it always prevents opportunities to extract monopoly rents, there is no doubt whatsoever that it sets a rate of return that attracts investors to the sector.

Any questions about this submission should be addressed to David Markham by email to [redacted] or by telephone on [redacted]

Yours sincerely,

David Markham
Networks and Distributed Energy Resources Policy Manager
Australian Energy Council

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[4] Independent Panel Report, AER Draft Rate of Return Instrument, P. 62

[5] Rate of Return Instrument Review: CRG Response to AER's Final Omnibus and Information papers, P. 11, 69, 76.

[6] Independent Panel Report, AER Draft Rate of Return Instrument, P. 40

[7] AER, 2022 Electricity Network Performance Report, P. 30

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