Consumer
Challenge
Panel

Advice to the Australian Energy Regulator (AER)

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Advice to the AER regarding COAG Energy Council draft legislation and rule changes for a binding Rate of Return Instrument

Sub-Panel CCP16

David Prins (chair)

Louise Benjamin

Eric Groom

Bev Hughson

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Introduction

The COAG Energy Council has agreed to make changes to the National Electricity Law (NEL) and the National Gas Law (NGL) relating to the calculation of the rate of return on capital and the value of imputation credits used in economic regulatory decisions.

The Senior Committee of Officials is seeking feedback on the draft legislation, particularly regarding implementation issues.

Stakeholders are invited to provide written submissions on the draft legislation and the drafting instructions for the consequential rule change by close of business on Friday 13 April 2018.[1]

The AER has requested that CCP16 provide its views to the AER by Monday 9 April, for the AER to input to the COAG Energy Council.

This document provides those CCP16 views.

Our advice focuses on the following areas:

- Re-opening of the instrument within a four-year period
- Removal of reference to the Allowed Rate of Return Objective (ARORO)
- Whether the new instrument should apply to all network determinations following its publication in December 2018

Each of these is considered in turn.

Re-opening of the instrument within a four-year period

The drafting currently states in 18U:

> (2) The AER must replace the reviewed instrument by publishing the new instrument on its website on the day that is the fourth anniversary of the day the reviewed instrument was published.
>
> (3) Despite subsection (2), the AER may replace the reviewed instrument before the day mentioned in that subsection if satisfied it should be replaced earlier to ensure the rate of return instrument will, or is likely to, contribute to the achievement of the national electricity objective to the greatest degree.

CCP16 is concerned that interested industry parties may use 18U(3) to lobby the AER continually for the instrument to be re-opened. Furthermore, it may result in an outcome that could be perceived as perverse: it provides for a broad exercise of discretion and hence uncertainty in an instrument that was designed to reduce / eliminate discretion within the four-year period, and increase certainty for consumers and for investors, who invariably take a long-term view of returns from utilities.

We believe that is not in the interests of the long-term interests of consumers as set out in the NEO or NGO.

[1] http://www.coagenergycouncil.gov.au/publications/national-electricity-law-and-national-gas-law-amendment-package-%E2%80%93-creating-binding-rate

The view of CCP16 is that the instrument should not be re-opened or remade within any four-year period. Rather, in the making now of the instrument, and every four years thereafter, the AER should be concentrating on ensuring that the instrument is robust to changes that may occur during the instrument's four year life. The instrument should include appropriate formulae to vary the actual rate of return as necessary.

CCP16 supports an approach where criteria are established when the instrument is first formulated, and then in replacement instruments, which set out unambiguously in what circumstances the rate of return is varied, and precisely what the rate of return change will be. This can all be achieved within the instrument. It does not require remaking of the instrument.

Our approach removes issues regarding the process that might be used by the AER in remaking the instrument within a four-year period. On the one hand a less rigorous process may be justified if a "quick change" is required to a specific element of the instrument. On the other hand, the remade instrument will itself then last for four years, so its formulation should have the rigour of a full review. In practice, if a full review were required after the case had been made to re-open the instrument, it would not be practical to re-open it in the last two years of its four-year duration.

As an alternative, if the legislation is to allow for reopening of the instrument during its four-year term, then we suggest that it would be preferable for the decision on reopening to be made by a third party, rather than the AER. This avoids the potential problem noted above of lobbying on the AER to re-open the instrument that may be perceived as opportunistic and increasing uncertainty. It may also reduce the concern that the decision to re-open may be seen to pre-empt the outcome of the review of the instrument. However, it does not address the timing concerns noted above. Removal of the re-opening provision would provide a better outcome for all stakeholders if it results in an approach that provides certainty while being more robust to changing economic conditions.

Removal of reference to the Allowed Rate of Return Objective (ARORO)

CCP16 supports removal of reference to the ARORO. CCP16 supports unambiguous focus on the NEO, the NGO and the Revenue Pricing Principles (RPP). These are appropriate objectives and principles for regulation based on economic efficiency, whereas the ARORO may be perceived to be grounded in finance theory or practice.

While a sound case can be made that the ARORO and NEO/NGO are consistent with each other, the experience with the debate on benchmarks for the cost of debt suggests that the concepts give rise to different considerations in practice. In its recent decisions, the AER has emphasised that the on-the-day rate is the efficient cost of debt in economic terms, and that the trailing average with transition achieves an NPV equivalent result. The arguments made in support of the trailing average without transition were grounded in observations of financing practice that may reflect differing risk appetites, and emphasised the recovery of debt costs that were sunk. It also led to a complex and unproductive debate on the benchmark efficient entity, which is imported through the ARORO. Removal of the ARORO removes any potential or perceived conflict between that and the NEO / NGO.

Whether the new instrument should apply to all network determinations following its publication in December 2018

CCP16 supports application of the new instrument to all network determinations, including determinations for NSW and ACT which are due by 30 April 2019.

All the network businesses, including those in NSW and ACT, have opportunity now and in the instrument's development to influence the instrument in the AER's regulatory process for creating the instrument, as well as participating in the process as members of ENA. There are therefore no natural justice or procedural fairness issues preventing the immediate application of the new instrument, and we support its immediate use.