AUSTRALIAN ENERGY REGULATOR – BETTER REGULATION PROGRAM

DRAFT RATE OF RETURN GUIDELINE

COMMENTS

October 2013

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1 Introduction

The Council of Small Business Australia (COSBOA) supports the need for better regulation in Australia, the Australian Energy Regulator's (AERs) involvement in this and the efforts of the AER to engage with consumers (and their representatives) in a meaningful way on its Better Regulation Program (BRP). COSBOA also appreciates the opportunity to provide written and other input to the BRP, including through this submission.

This submission responds to the AER's *Draft Rate of Return Guideline* and the accompanying *Explanatory Statement,* released in September 2013. We appreciate the considerable thinking, work and effort that have gone into producing these documents.

COSBOA has previously provided a submission on the AER's Rate of Return Consultation Paper in which it made detailed comments on many issues raised in that paper. Our comments in this submission are more targeted and respond to a selected number of matters raised in the Draft Guideline that are important to small business. These mainly relate to areas where the AER has revised its earlier position, or where we felt further comment was otherwise warranted.

Our previous submission also outlined why the rate of return for network service providers (NSPs) determined by the AER is important to small business, COSBOA's position on the rate of return, and established COSBOA's *bona fides* in relation to the BRP. A list of COSBOA members is attached to this submission.

The following section (2) comments on the Draft Guideline.

2 Our Comments

This section comments on various parts of the AER's Draft Rate of Return Guideline that are relevant to small business interests. As mentioned earlier, these mainly relate to areas where the AER has revised its earlier position or where we felt further comment was otherwise warranted.

2.1 Overall Rate of Return

We note the AER's intention to apply a nominal vanilla post-tax weighted average cost of capital (WACC) formula to determine the overall rate of return as required under the National Electricity and Gas Rules (NER and NGR). We support that this be done annually consistent with the proposal to determine the return on debt annually (see our further comments on this aspect of the draft Guideline below).

Whist we recognise the AER's desire to determine the overall rate of return as a point estimate, we believe that there would be value in also determining and reporting on a range for the rate of return. This will add to the transparency of the AER's regulatory decision-making and provide consumers with useful additional information about regulatory determinations.

The AER has formed a view that a paucity of data and comparability problems will limit it to the use of regulatory asset base (RAB) and trading multiples as reasonableness tests on the overall rate of return. COSBOA has concerns with this conclusion as it believes that there are significant benefits to be had from also examining the overall rates of return set by other regulators both here and overseas. This would provide valuable additional information to consumers as well.

To the extent that there are significant differences, this will also cause the AER to examine the reasons for these and explain them to stakeholders. Again, this can improve consumer knowledge and understanding of conceptual and empirical aspects of the rate of return. We concede that there will be comparability issues to overcome, but suggest that the AER can develop ways to deal with these and make essentially like-with-like comparisons. The AER should also seek the cooperation of other regulators, both local and overseas, in such an assessment, noting that they could also benefit from it.

2.2 Return on Equity

Whilst we recognise many of the points made by the AER in support of use of the Sharpe-Lintner CAPM (Capital Asset Pricing Model) as a 'foundation' model for determining the return on equity, supplemented by a range of other models and information, we also believe that the AER needs to apply this approach with care, particularly guarding against attempts to place undue weight on models, information or estimates that could inflate rates of return. The AER should not underestimate the capacity for strategic gaming of processes that involve choices and selection. The AER will need to ensure that it carefully scrutinises regulatory proposals with this in mind, exercises ultimate discretion/decision-making in determinations that fully reflect the National Electricity and Gas Objectives (NEO and NGO), and that proposals and choices/discretion are fully and transparently explained by both the AER and NSPs.

COSBOA makes the following additional points in relation to the proposed treatment of the return on equity:

- We support the use of the Sharpe-Lintner CAPM as the foundation model with the final choice of a point estimate for the return on equity to be informed by other models, such as the Black CAPM and Dividend Growth Model, along with other relevant information. We also support the use of the Wright formulation of the Sharpe-Lintner CAPM and other information listed in Table 5.3 of the Explanatory Statement to help determine a range for the return on equity. However, we would favour the addition of other regulators' WACC estimates (appropriately adjusted) to this list as we believe this will help to establish the appropriate range and add credibility to it.
- We do not support the use of the Farma-French model, given its well-known tendency to overstate the return on equity. The AER is correct in its proposal not to use it. Its use would be contrary to the NEO and NGO.
- We note the AER's proposal to estimate ranges for the equity beta and market risk premium (MRP) from which it will select a point estimate. The selection of this point estimate needs to be clearly explained, including the reasoning, and should reflect the NEO or NGO. As this will also led to a range for the return on equity, from which a point estimate will need to be determined, the same reasoning as in the first point above applies here and should also include reasonableness checks on the equity beta point estimate and ranges, so that full transparency is provided throughout the process. We note that the AER intends to include an estimate for the equity beta in the Guideline but will determine a MRP for each regulatory determination.
- The AER has said that its proposal to consider other information in determining the return on equity may mean that its final return on equity differs from the Sharpe-Lintner CAPM point estimate. Whilst the rationale for this is clear, it opens up scope for argument and conjecture such that we retain concerns that NSPs not be allowed to turn this into an opening whereby they gain an advantage over consumers in the processes for regulatory proposals, determinations and appeals.
- Our concerns are heightened by the AER's proposal to introduce a 25 basis points multiple in cases where there is a departure from the Sharpe-Lintner point estimate. The AER says that this approach "recognises the uncertainty inherent in estimating equity returns, but also provides an appropriate level of transparency, simplicity, certainty and replicability." (Explanatory Statement, p. 13) Whilst the AER's point about inherent uncertainty is taken, it is not clear to COSBOA from the Explanatory Statement why a multiple as significant as 25 basis points is needed? We have genuine difficulty in reconciling how this improves transparency, simplicity and replicability, although it does provide certainty (but at what cost)? We note that

the use of such a multiple could add significantly to network prices, given the sensitivity of these to changes in the equity beta. As the Explanatory Statement makes clear, typically a 25 basis point increase in the equity beta will increase the WACC by about 10 basis points (using the AER's parameters) and revenue by "less than one per cent". On this basis, for every $100 million increase in revenue, it would provide the NSP with a windfall of about $1 million. COSBOA would strongly urge the AER to revisit this proposal. We believe that a more modest multiple of, say 10 basis points on the equity beta, would be preferable and still be practical to implement. Of course, it is also possible that the impact could be in the opposite direction. However, our concern is greater where the impact of the grainier adjustment works to increase the WACC given the well-known tendency for inflated rates of return.

- We note the AER's comment that it expects its approach to setting the return on equity to result in more stable estimates in future given that the Wright approach to the Sharpe-Lintner CAPM is relatively stable over time. This would be of some benefit to consumers provided that, given our comments above, the overall approach does not result in increases in the return on equity such that would offset any benefits from stability.

2.3 Return on Debt

COSBOA is supportive of the AER's proposed use of a simple trailing average approach to establishing the return on debt and of annual updating of this. We believe this is more reflective of the NEO, NGO and rate of return objective, as well as providing a better representation of the actual debt financing practices of NSPs and other firms than the existing AER approach. We also note the AER's comment that it would smooth movements in the return on debt over time and so price volatility, which we recognise is consistent with the long term interests of consumers, other things being equal. On annual updating, we expressed ambivalence on this matter in our earlier submission, on the basis that the Consultation Paper did not sufficiently inform us on this and we sought further consideration and comment from the AER. We have considered the discussion in the Explanatory Statement and other published submissions and are supportive of annual updates, on balance. We concur with the AER that a 'menu' approach would not be consistent with incentive regulation or efficient debt financing, providing an NSP with an incentive to pick that approach which maximised its revenue.

In our previous submission, we supported the development of an in-house data base by the AER in preference to the use of third-party data. Whilst we are still inclined to this view, we have noted the discussion in the Explanatory Statement around this issue and the reasons for the AER's preference to use a third party data set. On this basis, we are not opposed to the AER doing so, but do consider that this involves some additional risks and shortcomings to consumers. In any case, the AER should keep under active consideration the option of developing an in-house data set.

However, we have a number of issues in relation to how the AER intends to apply its approach to the return on debt:

- We find the rationale for using a 7 year period unclear. We note that this term is not directly observable from third party data and will require a degree of extrapolation and/or interpolation. We also note that it does not accord with the 5 year term of the regulatory period which, for example, the ERA has adopted having found it to be consistent with current debt financing practice. Five year markets are also far more liquid and offer more accurate and consistent measurement. On this basis, we would support the use of a 5 rather than 7 year term, which would also be easier to implement.
- Use of a 5 year period would also lessen the need for a messy transition to the new arrangement. However, if the AER elects to use a 7 year period, in the interests of our members we would feel compelled to support a transition, given the additional risks to consumers, such as higher and more volatile rates of return and network prices. It has also been argued that a transition is required to allow NSPs to manage the change in regulatory settings, but NSPs do not seem to have managed their debt financing on the basis of regulatory settings in the past. Indeed, some of them have argued that a change from the current approach is needed to align better with how they do manage debt financing in practice. However, if the AER is still minded to apply a 7 year term with a transition, there should be a single transition method used (to avoid undue complication and scope for gaming), and the period should be kept as short as possible (no longer than one regulatory period).
- The approach to determining the return on debt should include consideration of the most competitive sources of debt finance as a core element of efficient debt financing, including sourcing debt from overseas.

2.4 Imputation Credits

COSBOA has considered and supports the AER's proposal to apply a 'gamma' value of 0.5. We note that this is significantly higher than the value currently used in AER determinations of 0.25. There appears to be sound rationale for this change based, as it is, on the AER re-evaluation of the treatment of imputation credits in regulatory determinations, particularly its focus on more accurately defining some conceptual issues and on support (including from empirical evidence) for a higher utilisation rate of 0.7 than has hitherto been applied. We also note that the re-evaluation undertaken by the AER appears to be consistent with points made by the Australian Competition Tribunal in its decision on gamma (i.e., that if the AER wished to support a higher utilisation rate it should undertake a broad re-evaluation and consult more widely) and that the focus of the Tribunal's decision was narrower than the AER's re-evaluation.

2.5 Other Comments

We have a number of other comments on the Draft Guideline that are set out below:

- We note the non-binding nature of the Guideline and the AEMC's requirement on this. Whilst we do not raise any objections to this, given the amount of work and consultation that has gone into the development of the Guideline, we strongly believe that it should be followed, by both the AER and the NSPs, unless there are strong reasons to depart from it. Any such departure should be clearly set out and explained so that consumers are fully aware of – and can understand – why there has been a departure. This expectation should be clearly set out in the final Guideline, which is what we understand the AER intends to do.

- Whilst COSBOA supports the trust of the AER's approach to compensating for risk, there is one important aspect where we have reservations. We mentioned in our earlier submission the problem that is created by not accounting for the fact that government owned NSPs face a significantly lower actual cost of capital than privately-owned ones. Setting a rate of return for the former as if they were privately owned has the effect of providing a pure windfall and imposing network prices on consumers that are too high and demonstrably inefficient. The AER not accounting for this in how it treats risk in setting a benchmark rate of return for the efficient entity will only perpetuate high network prices in those jurisdictions with government owned NSPs. The AER referred in the Explanatory Statement to support for its position from the Productivity Commission (PC). However, the PC's position should not be taken out of context. It formed its view on the basis that the rationale for government ownership of electricity networks "no longer holds", that these networks are inefficient and that privatisation is the best remedy (or in its absence government owners should reinstate the original intent that they act as truly independent entities). As neither is the case at present, in our view, in the meantime there is (and remains) a strong case for differentiating the benchmark in the case of government ownership. To do otherwise is clearly not in the long term interests of consumers of electricity. If the AER feels that this would not be consistent with the Rules, COSBOA would encourage it to seek clarification of this from the AEMC and, if necessary, propose a Rule change. The AER could also write to the SCER and point out the anomaly which this problem creates for network regulation and the NEO/NGO.
- We note comments made by other consumer representatives that gearing for energy networks are higher than the benchmark efficient firm assumption of 60 per cent debt. Reference has been made to a recent *AFR* article, which showed gearing levels for DUET (78 per cent), Envestra (68 per cent), Spark (72 per cent), and SP AusNet (71 per cent). It has been pointed out that this is relevant in two ways. First, debt typically is cheaper than equity so that the lower assumed gearing in AER determinations supports a higher rate of return than the benchmark firm in actuality. Second, higher actual debt levels affect the benchmark credit rating. Firms with a 60 per cent gearing would typically have a higher credit rating than the benchmark firm. In other words, a real firm with 60 per cent debt would typically have a higher credit rating than assumed for the benchmark firm. Therefore, the combination of 60 per cent gearing and a BBB+ credit rating for the benchmark firm is too conservative. Firms would either have a higher credit rating at 60 per cent debt or higher levels of debt for a BBB+ credit rating. This artificially pushes up the rate of return and network prices, which is not in the long term interest of consumers of electricity and gas.
- There have been some suggestions that NSP's are arguing that aspects of the BRP approach being developed by the AER increases risks to them (e.g., through the possibility of *ex* post reviews of their capex) and that they should be compensated for this through a higher rate of return. COSBOA would strongly object to any increase in the rate of return based on this argument. First, any such recognition needs to be viewed holistically. There are other

elements of the BRP that work in the opposite directions, such as the proposal to have an annual review of the return on debt, which provides the NSPs with greater certainty. Secondly, *ex post* reviews were previously a feature of network regulation and actually posed very little, if any, additional risk to the NSPs. Thirdly, it could justifiably be argued that NSPs have hitherto been overcompensated and that the BRP is merely reducing the extent to this. For example, it is well recognised that some NSPs have inefficiently overspent capex allowances and the BRP changes will return capex spending to more efficient and prudent levels, a fundamental tenet of incentive based regulation and such changes are not something that NSPs should be compensated for. The ability to apply an *ex* post review of capex is part of this. Similarly, the changes to the rate of return framework are consistent with the NEO, NGO and rate of return objective, including that NSPs receive a risk adjusted regulated return that is commensurate with the benchmark return of an efficient entity. Compensation beyond this would not be consistent with these objectives.

- For small business, which has practical difficulties in coming to terms with regulatory complexities in many facets of business, improving the clarity and transparency of regulatory processes and decisions is important. Setting the rate of return for electricity and gas networks is significant in the network prices they pay, but is difficult for them to understand. A major reason for this is the extremely complicated and arcane nature of the approach taken. This is a major impediment to small business understanding the AER's decisions and to their participation in AER reviews. Although COSBOA's participation in the BRP has assisted in addressing this matter, the degree of complexity that will remain in future is a major challenge for small business. Accordingly, we would have preferred that the AER had taken the opportunity of developing a Rate of Return Guideline that was more straightforward for small business to come to terms with, particularly given that one of the rate of return criteria proposed by the AER is to "promote simplicity over complex approaches where appropriate" (Explanatory Statement, p. 27). In any case, COSBOA believes that it will be important that the AER and the Consumer Advocacy Panel (CAP) find ways to ensure that small business is better informed and educated about rate of return approaches used by the AER. For example, we understand that the AER conducts training courses on network regulation, including the rate of return, and it would be useful to invite small business representatives to attend these. In addition, the CAP could give consideration to how it could assist small business (and COSBOA) in this direction through capacity building. Unless there is continuity in addressing the challenges small business has in understanding the complexities of network regulation, any gains made through COSBOA's participation in the BRP will soon be dissipated.

ATTACHMENT: List of COSBOA Members

Australasian Association of Convenience Stores

Australian Booksellers Association

Australian Digital Television Association

Australian Equipment Lessors Association

Australian Hairdressing Council

Australian Human Resources Institute

Australian Livestock and Rural Transporter Association

Australian Newsagents Federation

BPW Australia (Australian Federation of Business and Professional Women)

Business Enterprise Centres Australia

CITT (Council of Information Technology & Telecommunications)

Commercial Asset Finance Brokers Association of Australia

Convenience and Mixed Business Association

Fitness Australia

FSV

Independent Retailers Organisation

Institute of Public Accountants

National Financial Services Federation

National Independent Retailers Association

Pharmacy Guild of Australia

Pittwater Business Limited

Real Estate Institute of Australia

Stocktakers Institute of Australia

Tasmanian Small Business Council

University of Western Sydney