AER Consumer Reference Group

AER Public Forum

CRG's preliminary response to the AER's Draft Debt Omnibus Paper

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Who we are

AER
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Reference Group

- An independent group set up to:
  - Advise the AER on its consumer engagement, and
  - Represent the perspectives and interests of consumers
  - In the context of the RORI review.
- Our role derives from the National Electricity Law and National Gas Law.

- https://www.aer.gov.au/about-us/stakeholder-engagement/consumer-reference-group

Outline

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- CRG's consumer-oriented principles and use of the EICSI
- The economics of setting the RoD
- Comparing the options
- Is replicability necessary?
- Transitions
- Removal of benchmark credit rating
- NSP arguments on the EICSI
- In conclusion

Our consumer-oriented principles (1)

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Principle 1 – A regulatory framework serving the long-term interests of consumers must promote behaviours that engender consumer confidence in the framework

- **CRG**: The use of actual NSP debt costs in setting the RoD is consistent with this principle. Feedback from consumer reps is supportive of this approach.

Principles 2/3 – Any change to the regulatory model must be tested against (2) detrimental consumer impacts in relation to absolute prices and price changes/(3) acceptable consumer impacts in relation to service levels

- **CRG**: The EICSI indicates NSP actual debt costs are lower than the 2018 benchmark. Using the EICSI has potential to lower consumer costs/prices.

Our consumer-oriented principles (2)

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Principle 4 – Risks should be borne by the party best placed to manage them

- **<u>CRG</u>**: NSPs still carry the risk in relation to their own ability to match/beat the RoD benchmark. Consumers still bear the risk of a general rise in interest rates.

Principle 5 – There should be a high bar for change

- **<u>CRG</u>**: The development and refinement of the EICSI represents a substantive new body of evidence in relation to actual NSP debt costs.

The economics of setting RoD

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Considerations

- Is the method transparent and simple to explain and implement?
- What are the incentive properties of the method?
- Do gains by NSPs get shared with customers?
- Who bears the risks?
- How does the method fit with the rest of the RoRI?

Comparison of some options

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Method	Simplicity	Relation to NSP actual costs	Incentive to beat	Customer benefits from out-performance	Risk allocation
Simple *ex ante* fixed instrument	Simple	None direct	Yes	No	Risk with NSPs
TA (2018)	Medium complexity	None direct	Yes, but can choose to match	No	Mix
TA with EISCI + capex weights	High complexity	Some	Yes	Yes, at next reset	Mix
Pass-through of embedded debt	Simple	Total	No	No	Risk with customers

Replicability

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NSPs appear to believe that RoD method <u>must</u> be replicable. This is not the case.

- Must be adequate, i.e. should provide a sufficient allowance for a benchmark efficient entity to finance itself.
- Replicability is a way to test adequacy, but not a necessary condition of adequacy.
- Adequacy is linked to trust and confidence in the process.

Transitions

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- Replicability argument links to need for transitions.
- Not seeking to reprosecute 2013 decision, but taken a long time to unwind.
- Preliminary view – none of proposed changes merits transition.
- Would be good for AER to explore what conditions do merit transition, rather than consider *ad hoc.*

Removal of benchmark credit rating

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- The proposed application of the EICSI means a move away from a benchmark credit rating for RoD.
- What are the implications of this?
  - Can't cross check to gearing.
  - No basis for adjusting RoD if gearing changes.
  - No reference point for credit rating if financeability cross-check carried out. Could still target investment-grade.

Weighting the trailing average

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- What is materiality of capex weighting vs 1/10 weighting for NSP in "steady state"?
- Per AER assessment criteria, need to know if it is material to proceed.
- If individual NSPs have issue with capex profile, then are changes required across the board, or can AER take targeted approach (cf Ofgem).
- CMA and water appeals – there is plenty of room for disagreement about how to weight in practice and what the resulting weighted average RoD is (c 40-50bp).
- Risks of gaming? Perverse incentive to spend less capex when rates are low?

NSP arguments

- December 2020 Memorandum:
  - Outperformance only due to average tenor (WATMI) of EICSI < 10 years.
- Submission to “Terms” working paper:
  - WATMI is c. 10 years in any case.

Hard to fully reconcile these two…

In any case if:

A. there is no outperformance except that due to tenor; and

B. the tenor is similar to 10 years; then

what is the objection to using the EICSI? It will presumably produce a very similar result to existing BBB+ 10 year TA approach, albeit by a more complex route.

Conclusion

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- **In principle, a method that sets the allowed RoD to better reflect the actual NSP cost of debt is to be welcomed.**
  - Recognise the value of an EICSI based method in allowing consumers to benefit from NSP outperformance.
  - Captures potential "halo effect" of regulated utility debt issuance.
- **New proposals add further complexity to RoD calculations.**
  - Need to understand materiality of capex-weighting.
  - AER will face constant battle with NSPs over details, and other stakeholders will lack resources to effectively participate.