AER Consumer Reference Group

By email

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CC
Mr Eric Groom PSM
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Dear Clare

Re: The long-term interests of consumers and the regulated Rate of Return

Thank you for the opportunity to meet with yourself and the Network Committee on the 24 March 2021. The Consumer Reference Group (CRG) welcomes the AER's efforts to develop a guiding principle linking the Rate of Return (RoR) with the objective of efficiency "for the long-term interest of consumers" (LTIC), as articulated in the national electricity and gas objectives (NEO & NGO). We support the AER's intent to closely examine this concept in the context of preparing the 2022 Rate of Return Instrument (RoRI)

In its discussion with the CRG, the AER's Network Committee proposed the following draft principle to explain the role of the LTIC in its decision-making:

> *Seek an unbiased estimate of the efficient cost of capital, consistent with risks, and the rate of return should neither be too high, nor too low*

The first part of this proposed principle reflects previously expressed principles for determining the cost of capital (CoC). The latter part, "neither too high, nor too low", seeks to express an approach that has not been previously formalised. We offer the following reflections on the two parts of the draft principle.

We believe it would be helpful if the first part of guiding principle were drafted to be more comprehensive and self-contained – thereby avoiding different interpretations of its intentions. We offer the following suggestions:

- ***long term interests of consumers*** – It would be helpful if the principle explicitly linked the AER endeavours with the LTIC.
- ***"unbiased estimate"*** – This reference points to the estimation techniques the AER adopts for estimating the CoC. It should also reflect a desire for efficient estimates (that is, an estimate with relatively low variance based on the relevant data)
- ***"efficient"*** – In this case, the term 'efficient' refers to the operation of a benchmark entity rather than individual networks. It would be helpful if this were made clear.
- ***"cost of capital"*** – We suggest including a reference to the *long-term* cost of capital to confirm that individual determinations are not captive to contemporary business, regulatory or investment cycles.

  The development of the proposed principle also creates an opportunity for the AER to clarify that its regulatory task is to provide compensation for funds invested – rather than to offer an incentive to attract investment.
- ***"consistent with risks"*** – It would be helpful to clarify this is referring only to systematic risk, and that the level of systematic risk for which compensation is being provided must be defined as far as possible[1] ahead of a RoR decision.

We now turn to the second part of the draft principle and its reference to ***"the rate of return should neither be too high, nor too low"***.

This term is unusual and it invites the following questions.

- What does it mean at the point of a regulatory decision? How would the AER or its stakeholders test or confirm it has been applied correctly?
- Why is it required if the AER is also seeking an unbiased estimation methodology?
- It could be (mis)interpreted as the AER seeking to make subjective judgements that balance competing interests although that is not what is required by the national energy objectives.

Moreover, the reference to *"neither be too high, nor too low"* could lead to the conclusion that the AER will gravitate to the centre of the estimation range produced by its estimation methodologies. While simple, this approach may introduce a bias if the estimate's underlying distribution function is skewed left or right –therefore, conflicting with the principle's desire to identify an unbiased estimate.

[1] The CRG notes that a limiting factor to this approach may arise in which changes to the RoR instrument may themselves impact the level of systematic risk, in either direction.

[2] DER provides consumers with some opportunity to 'walk away' but until total grid defection becomes a

In light of these limitations, we believe the reference to *"neither be too high, nor too low"* risks embedding a definitional circularity in the proposed principle which could prove troublesome in its application.

This has led us to reflect more deeply on the overall task of the guiding principle, which in turn leads to an even deeper question about what is being targeted by virtue of the reference to the ***"efficient cost of capital"***. The term *"neither be too high, nor too low"* does not, per se, help answer this question.

In seeking a more definitive and objective principle, and one that avoids the problem of circularity, we suggest an answer may be found in applying auction theory to the problem.

Using auction theory to clarify the regulatory principle

In the following text box, we outline some general principles borrowed from auction theory as they apply in an open and competitive market. We then suggest how this theory can be applied to better understand the relationship between consumers and monopoly providers of an essential service (such as energy networks).

Some general principles borrowed from auction theory

In a conventional commercial situation, a vendor would enter the negotiations knowing its *reserve price* – that is, the minimum price it would be prepared to accept in order to deliver the services wanted by consumers. Conversely, a consumer would enter the negotiation knowing their *valuation price* – that is, the maximum price they are prepared to pay for the services they want. The consumer would not know the investor's reserve price, and the investor would not know the consumer's valuation price.

If the valuation price is below the reserve price, the negotiations will fail and the parties will walk away without striking a deal. If the reserve price is below the valuation price, the parties will eventually strike a deal and the final price will lie somewhere between the reserve and valuation prices. The final price will depend on the structure of the negotiations and the negotiating tactics deployed by each side as they seek to discover the other party's walk-away price. Importantly, any settlement between the reserve and valuation prices will be an efficient outcome.

When it comes to electricity and gas networks, the notional negotiation envisaged in auction theory is between consumers and investors. They would be negotiating over the price of capital (i.e. the RoR). However, in this 'negotiation', the great majority of consumers cannot readily walk away as they might in a competitive environment. Electricity and gas are essential services, and while rooftop solar is becoming prevalent, for the foreseeable future this is complementary to grid supply rather than a genuine substitute.[2] This leaves consumers with very limited or even no negotiating power in many instances.

Alternatively stated, the valuation price is infinite for these consumers. Powerless consumers are therefore at risk of exploitation through the extraction of economic rents by monopoly network service providers. Such outcomes can also impose a dead weight loss on the broader economy when consumers make inefficient decisions regarding their use of energy and investment in energy-using appliances (as well as houses and other buildings).

In this context, any price above investors' reserve RoR represents a transfer from consumers to investors that exceed the rate necessary to attract capital to, and retain it in, the provision of network services. In other words, if the AER were to provide a rate that exceeds investors' reserve RoR, it would be sanctioning an economic rent. Economic rents are the antithesis of economic regulation and the legislative objective of "[efficiency] *for the long-term interests of consumers"*.

The draft principle's reference to *"neither be too high, nor too low"* does not unambiguously reflect the regulatory task of avoiding economic rents in the provision of network services.

Other relevant regulatory principles

The CRG observes that the principle proposed by the AER, while important, does not on its own cover all relevant aspects of the AER's decision-making in the context of the RoRI. Accordingly, further principles merit consideration.

During the inflation review, the CRG recommended the AER take into account several consumer-oriented principles. While the objectives and principles set out in the NEO/NGO and the revenue and pricing principles remain the priority for the AER, the consumer-oriented principles add to the AER's understanding of the actions required to ensure their decision reflects the long-term interests of consumers.

We therefore consider these, and the overarching principle that consumer interests are well served by the application of a high bar for change, remain relevant to this review, potentially with some modifications. We also consider that consumer perspectives in themselves have a role to play alongside cogent technical arguments relating to economic efficiency.

Areas for further discussion

There are several issues raised in this letter that go beyond the scope of the AER's LTIC principle, but are nevertheless important in understanding the full implications of the AER's obligations in the RoRI. These include:

1. the role of the CRG's consumer-orientated principles in the context of the Rate of Return Instrument, including our emphasis on the 'high bar for change' principle;

[2] DER provides consumers with some opportunity to 'walk away' but until total grid defection becomes a realistic option, consumers are still bound to the grid and the notional negotiations described here.

2. an interpretation of the NEO/NGO's reference to 'investors in network services' which reflects the returns required by investors who hold a long-term investment outlook that aligns with the long-lived nature of network assets; and
3. the avoidance of dead weight losses (ie. the economic concept of welfare loss) resulting from network prices that embody an economic rent in the RoR.

CONCLUSION

Taking all these matters into account, we propose the following revised principle:

> *The long-term interests of consumers are met when the AER seeks an unbiased and efficient estimate of the minimum long-term cost of capital required to attract and maintain investment in a benchmark efficient network service provider.*[3]

The CRG would welcome the opportunity to work with the AER on further developing guiding principles in the long-term interests of consumers.

Yours sincerely

Bev Hughson
Chair, Consumer Reference Group

Mobile: [redacted]

[3] Note: The term "cost of capital" could be replaced by a reference to "compensation for systemic risk", such that the principle would read:

> *The long-term interests of consumers are met when the AER seeks an unbiased and efficient estimate of the minimum long-term **compensation for systemic risk** required to attract and maintain investment in a benchmark efficient network service provider.*