AER
Consumer
Reference Group

# AER public forum
# Term of the rate of return

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# What is the CRG?

Our role derives from the National Electricity Law and National Gas Law

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

Bev Hughson – Chair

Kieran Donoghue – Deputy Chair

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|---|---|---|
| Allan Asher | Helen Bartley | Ron Ben-David |
| Jo De Silva | Craig Memery | Alex Oeser |
| Lynne Gallagher (ECA) | | |

# OUTLINE

Our focus today is mainly on the AER's proposed approach to estimating the return on equity (RoE).

A. Four questions consumers might ask about the proposal in the Terms paper

   1. Does the proposal have an accepted theoretical foundation?
   2. Can the proposal be applied effectively and efficiently in practice?
   3. Are the circumstances necessitating the proposal clear?
   4. Are the consequences of the proposal clear?

B. Correcting the record

C. Assessing the proposal against the CRG's five principles

## 1. Does the proposal have an accepted theoretical foundation?

The Terms paper refers to an “evolution in [the AER’s] thinking” about how it satisfies the NEO/NGO, reflecting its decision to target NPV=0 in each regulatory period (5 years) – rather than over a term proxying long-lived investments (10 years).

### CRG observations

- The AER has unilaterally reinterpreted its “regulatory task”.
- The AER is not consulting on the theoretical foundation of its re-interpreted “regulatory task”. The working paper treats this as a foregone conclusion.
- The AER is only consulting on *how* it should implement its reinterpreted “regulatory task” – but notes it has already begun implementing it reinterpreted task (ie. in its inflation decision, December 2020).
- The AER explains its new approach is largely based on papers from Dr Martin Lally (including recent papers).

## 1. Does the proposal have an accepted theoretical foundation?

**CRG observations (cont…)**

- The AER has not subjected its reinterpretation to independent expert review or public consultation – despite noting, "Estimating the rate of return is difficult and contentious."
- The Terms paper acknowledges ~20 years of past practice but does not suggest this approach was wrong.
- Terms paper recognises experts and other regulators remain divided.
- No evidence of a recent shift or convergence among experts and regulators in support of the AER's re-interpreted regulatory task (NPV=0 over the regulatory period).

**CRG: The AER has not established / demonstrated the basis for its theoretical "evolution".**

## 2. Can the proposal be applied effectively and efficiently in practice?

The AER is proposing the estimation term for RoE should match the term of the regulatory period (5 year); while the term for RoD should (i) depend on the form of the return on debt, and (ii) continue to be set using a trailing average return on debt

### CRG observations

- The AER's revised interpretation requires forward-looking, expected estimates for RoR.
- No methodological information provided. Therefore, no way of judging how well the AER expects to achieve its "regulatory task" in practice.
- The 5 year RFR is observable and likely to be lower than 10 year RFR, which is welcomed.
- But expected values for MRP and beta (other?) cannot be observed *ex ante* nor verified *ex post*. Historical data may be less relevant than currently.
- Estimates will be speculative, unverifiable, more contentious and subject to dispute (read: lobbying) than currently. This will favour well-resourced and organised stakeholders.

## 2. Can the proposal be applied effectively and efficiently in practice?

**CRG observations (cont…)**

- No discussion about how these practical constraints can be overcome to ensure the proposed approach will produce more efficient outcomes for consumers.
- Dr Lally's advice on RoD was nuanced. Terms paper does not address this nuance.
- We recognise the current approach faces practical constraints which means it is 'third best' but no assessment is provided to suggest the proposed approach will be better than 'third best' once its constraints are taken into account.

**CRG: The AER has not established / demonstrated it can be applied efficiently in practice.**

## 3. Are the circumstances necessitating the proposal clear?

The Terms paper explains the risks of over- or underestimating the RoR are:

- (i) over- or under investment in network assets
- (ii) distorted consumer prices leading to inefficient consumer decisions
- (iii) inability to attract funds (if RoR underestimated)

**CRG observations**

- No evidence has been provided of (i) under or over investment, (ii) inefficient consumer decisions, or (iii) networks being unable to raise capital.
- No evidence of harm being done to the long term interests of consumers from (i) declining service standards, or (ii) unnecessarily high prices.

**CRG: The AER has not established / demonstrated a clear driver for change.**

## 4. Are the consequences of the proposal clear?

The NEO/NGO promotes efficiency *for* the long term interests of consumers. Those interests are referenced with respect to price, quality, safety, reliability and security.

**CRG observations**

- No evidence is provided (nor arguments made) suggesting that the proposed arrangements will better achieve the long term interests of consumers with respect to price, quality, safety, reliability and security.
- The terms paper tangentially suggests proposed arrangements lower risk, but does not discuss how those benefits will be realised or shared with consumers.
- No quantitative analysis of the impact of the change in term of the RFR is provided, nor is there consideration of how the change will affect the estimation of other RoR components.
- The terms paper provides no indication what might trigger a further "evolution in [the AER's] thinking" or what the threshold for such a trigger might be.

**CRG: The AER has not explored / demonstrated the 'real world' benefits of its proposal.**

# B. Correcting the Record

"The 2018 Rate of Return Instrument (2018 Instrument) process set the term for the rate of return as ten years for both the return on equity and return on debt and we previously determined a ten-year estimate of the expected inflation. However, in the 2020 Inflation Review we decided to match our estimate of expected inflation to the length of the regulatory period (typically five years)." (p.2)

"At the time, we were satisfied that we could consider the terms for inflation and rate of return separately." (p.3)

**This was despite very strong advice from the CRG (6 November 2020)**

"[T]he AER cannot make a decision on its methodology for estimating inflationary expectations ahead of its consideration of the rate of return instrument (RoR). These are completely interwoven elements of the regulatory framework. The CRG is also concerned a pre-emptive decision on estimating inflationary expectations, may prejudice the AER's later decisions regarding the rate of return instrument."

**The Terms paper misrepresents our advice when it states:**

"[The CRG] made a submission that we should employ a consistent approach to term across our inflation and rate of return estimates <u>and therefore we should also change the term for our rate of return</u>." (p.3)

**The AER has (verbally) acknowledged this misrepresentation but has not entertained reconsidering its decision on the term for estimating expected inflation.**

# C. Assessing the proposal against the CRG's five principles / criteria

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

***Principle 2 – Any change to the regulatory model must be tested against detrimental consumer impacts in relation to absolute prices and price changes.***

***Principle 3 – Any change to the regulatory model must be tested against acceptable consumer impacts***

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

***Principle 5 – There should be a high bar for change.***

**Interviewing the Terms Paper ("Terms")**

| | |
|---|---|
| RBD: | Why is this paper necessary? |
| Terms: | Because there's been an evolution in our thinking |
| RBD: | About what? |
| Terms: | Our regulatory task. |
| RBD: | Why does that matter? |
| Terms: | Well, our regulatory task takes precedence. |
| RBD: | Over what? |
| Terms: | Our previous thinking about our regulatory task. |
| RBD: | So can we continue estimating a long-term RoR? |
| Terms: | Well, actually, no. |
| RBD: | Why not? |
| Terms: | Because it's no longer consistent with the regulatory task. |
| RBD: | How come? |
| Terms: | Because there's been an evolution in our thinking. |

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

As per the above dialogue, the purpose of the AER's consultation is not clear. The logic of the paper is a closed loop.

Rather than starting with consultation on the big picture decisions (ie. the "regulatory task") and working down into the detail, this review sequentially deals with the details.

Each decision is necessitated by the previous one, but no decision takes into account its impact on future decisions. Each decision narrows the options for future decisions.

This 'path dependence' does not feel like it is promoting a genuinely open-ended consultation with consumers.

The big picture will only be revealed after all the details are settled, by which time it will be too late to change any of those details.

A regulatory review is not meant to be a mystery novel.

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

What surprises await?

What options will no longer be available in the future because of prior decisions?

How do we, the CRG, pursue customers' interests in this environment?

CRG: We're finding it difficult to feel confident about this review process and how the CRG can effectively represent the interests of consumers.

# Assessing the proposal against the CRG's five principles / criteria

***Principle 2** – **Any change to the regulatory model must be tested against detrimental consumer impacts in relation to absolute prices and price changes.***

CRG:  No assessment provided by the AER

***Principle 3** – **Any change to the regulatory model must be tested against acceptable consumer impacts***

CRG:  No assessment provided by the AER

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

CRG:  Some suggestion the proposal lessens risk but not how that benefit would be shared with consumers.

***Principle 5** – **There should be a high bar for change.***

The working papers recognise the challenge associated with reviewing the RoR.

> *"Estimating the rate of return is difficult and contentious. It requires regulatory judgement to assess the complex and sometimes conflicting evidence; and to engage with finance theory, academic literature and market practice. There is no one 'right answer' to be found."*
>
> (Terms paper, p.2)

> *"For return on equity, experts and regulators often reach differing positions on the strengths and weaknesses of different models and how those models should be implemented."*
>
> (LIRE paper, p.22)

These quotes would seem to suggest that a change to the regulatory approach should only proceed when a comprehensive case for change has been made.

***Principle 5 – There should be a high bar for change.***

Our preliminary discussions with consumer representatives suggest they value stability in the AER's approach and where change is proposed, there must be strong evidence supporting that change.

The four questions asked at the start of this presentation highlight that no such evidence has yet been presented.

The only 'evidence' for change seems to be the "evolution in the [AER's] thinking".

CRG: The Terms paper has not provided the evidence required to support change. It has not met the high bar that consumers (and the CRG) expect.

# CONLUSION

The CRG has identified four questions that, if answered, would underpin the case for change to the term of the RoE.

*The Terms paper's has not yet answered any of those questions satisfactorily.*

The CRG has applied its five principles to assess the RoE proposal in the Terms paper.

*We consider the Terms paper has not yet met any of these criteria.*

*Our preliminary discussions with various stakeholders confirm this assessment.*

*We intend to share stakeholders' feedback with the AER and seek further explanation of the AER's proposal.*