EUAA
Energy Users Association of Australia

EUAA submission – AER Rate of Return Review Issues Paper October 2017

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Introduction

The Energy Users Association of Australia (EUAA) is the peak national body representing major Australian electricity and gas users. Our membership covers a broad cross-section of the Australian economy including significant retail, mining, manufacturing, materials and food processing industries.

The EUAA is a strong advocate for energy users and firmly believe that the primary objective of energy markets should be to serve the long-term interests of the consumer as stated in the NEO and NGO. There can be no doubt that energy users, both large and small, are experiencing unprecedented increases in both electricity and gas costs while there are potentially significant risks to both the availability and reliability of energy for some consumers. This situation is clearly at odds with both the NGO and NEO.

Over the last 10 years Australia has given up its comparative advantage in competitively priced, highly reliable energy that has underpinned significant industrial development and employment for many decades. It is inconceivable to think that a country with resources that are the envy of the world cannot deliver competitively priced energy to its own population. If allowed to continue on this trajectory this comparative advantage will be permanently lost and along with it, a majority of energy intensive industry including many industrial, food processing and manufacturing industries.

The recent ACCC review of found that increases in network charges were by a large margin the major cause of increases in delivered prices to both residential and C&I customers over the period 2007-2016[1]. Return on capital accounts for 50-55% of total allowable revenue for electricity and gas networks[2].

Given this context the EUAA welcomes the opportunity to comment on the Australian Energy Regulator (AER) Issues Paper "Review of the rate of return guidelines" published in October 2017. Debates on various aspects of measuring WACC have occupied far too much time and effort of all stakeholders since the publication of the 2013 Guideline. This has been to the detriment of good regulatory outcomes.

[1] ACCC "Retail Electricity Pricing Inquiry – Preliminary Report" 22 September 2017 p. 35 and p.50
https://www.accc.gov.au/system/files/Retail%20Electricity%20Inquiry%20-%20Preliminary%20report%20-%2013%20November%202017.pdf
[2] AER "State of the Energy Market May 2017" p. 103
https://www.aer.gov.au/system/files/AER%20State%20of%20the%20energy%20market%202017%20-%20A4.pdf

The EUAA is a member of the AER's Consumer Reference Group for this matter and we thank the AER for establishing it. We look forward to making a contribution both through that group and in further submissions to this process.

This submission begins with a discussion of some high level issues and then addresses each of the Questions asked by the AER in its Issues Paper.

The current guideline has not achieved the NEO/NGO

While the AER claims (p.8) that:

> "Our view is the allowed rates of return we have set when applying the current Guideline have achieved the national electricity and gas objectives, as well as the allowed rate of return objective."

it provides little evidence for this proposition. Later in the Issues Paper, in response to the question that consumers raised at the pre-issue paper forum "if you are planning to use the current approach as a starting point, how do you know if your current approach is working?", the AER noted (p.15):

> "This is an important question, yet it is difficult to come to a definitive answer."

Our view is that the 2013 Guideline has not met the NEO and NGO objectives. There is a perception in EUAA members that:

- the allowable WACCs are higher than the risks allocation between networks and consumers would suggest. Our members would welcome the opportunity to earn the almost guaranteed returns networks are given thought the AER reset process, and
- limited evidence suggests that the actual profitability of regulated networks may be much higher than the allowed WACCs in an incentive regulation framework, suggest. The AER has no agreed measure of actual profitability to be able to test the efficiency of regulatory outcomes.

Consumers have received a safe and reliable service. Unfortunately, we believe it has been achieved with far too much capital investment (see the fall in capacity utilisation rates) and poor productivity by many networks with the result that prices are far too high. Many networks are not at "benchmark" efficient levels and yet they continue to earn a secure revenue flow that produces, what limited evidence suggests, to be above normal profits for a regulated natural monopoly.

We support in principal the process approach of the AER

Given the considerable work undertaken to develop the 2013 Guideline and debate since, the EUAA, in principle, supports the proposed "incremental" approach of the AER to develop the new binding Guideline.

We see no benefit is re-prosecuting matters that are well settled through recent AER decisions and Tribunal and Court rulings. We do support the rigorous consideration of the available data that informs the selection of particular values for key variables. This may mean that in some cases a more that "incremental" approach is warranted. One example might be the limited number of listed entities available to benchmark against.

We support the use of the current evidence sessions and the independent panel review.

On timing, we consider that May 2018 is too early to publish the "Draft Guideline". Instead, the paper produced in May should indicate the direction the AER is heading on major issues which would then provide context for both further consultation including the invitation for further submissions, and the independent

panel review process[3]. May is far too early to come to almost definitive conclusions in a process that does not finish until December.

The EUAA strongly supports the development of a binding guideline.

Following implementation of the 2013 Guideline, the consumer expectations that WACC debates would fall was not borne out – in fact the opposite occurred. Many networks continued to debate aspects of the guideline at each revenue reset with the AER and then if they could not achieve their preferred position, sought appeals to the Tribunal and the Federal Court.

While the abolition of Limited Merits Review has taken away a major risk factor for consumers, we do not wish to see a continuation of extended WACC debates among stakeholders continuing at each revenue reset. While consumers await the outcome of the current COAG review on funding of consumer participation in revenue resets, there is a large information and resources asymmetry between consumers and networks which is a major barrier to consumers participating in the revenue reset process.

Importantly, the binding guideline will also free up the AER to focus more on producing an outcome that better meets the NEO/NGO rather than one that looks more to protecting their position in any appeal process.

We look forward to more detail on what is meant by a "binding" guideline

In July 2017 the COAG Energy Council agreed that the guideline to be developed by the current process would be "binding". This would replace the existing 2013 Guideline that is "non-binding". Until the legislation is published, the only guidance on what "binding" means is provided by the COAG SCO Bulletin[4]:

> "Give the AER and WA ERA the power to make a legislative instrument that specifies a mechanistic approach for the AER and WA ERA to use to determine the rate of return and the value of imputation credits (i.e. gamma) for economic regulatory determinations;"

"Mechanistic" can take a number of forms eg:

- Equity rate of return = Risk free rate +x%, or
- Equity rate of return = Risk free rate + ((Market risk premium (calculated in this mechanistic way) * beta (calculated in this particular way))

So the only variable required might be the risk free rate.

It also has to have parameters around what circumstances would trigger a reconsideration of any part of the guideline during the 5 year application period eg a GFC type event?

The EUAA looks forward to the draft legislation providing the required detail around these matters.

Consumers need to have confidence in the regulatory structure

Measuring the success of the regulatory regime is not just by a regulator or the regulated concluding that it is delivering the National Electricity and Gas Objectives. It is also consumers having the confidence and

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[3] A recent example of the suggested approach is the AEMC "Review into the scope of economic regulation of covered pipelines" which prepared a stakeholder meeting discussion paper for a meeting on 14th December 2017 http://www.aemc.gov.au/getattachment/a8aad2c6-61ce-41b1-8190-93f14af3d6ff/Discussion-paper.aspx

[4] COAG SCO Bulletin "Binding Rate of Return Guideline" October 2017 http://www.coagenergycouncil.gov.au/sites/prod.energycouncil/files/publications/documents/SCO%20Bulletin%20Binding%20Rate%20of%20Return%20Final.pdf

perception that the system is delivering these objectives. They do not read the Electricity of Gas Rules, but rely on COAG to set the right rules and the AER to implement them efficiently. They do, however, very closely read their electricity and gas bills and this is a prime reference point for measuring their level of confidence.

Like their own businesses, they are comfortable with a network earning a return commensurate with the risks the networks face and operating in a benchmark efficient way with regard to its investment and operating decisions. Consumers need to have confidence that the regulatory structure does not lead to monopoly rents and behaviour eg through regulatory capture or gaming the system. Once this appears, there will be a rising lack of confidence in the regulatory regime, which, if not addressed through the regime, will bring pressure for a politically imposed remedy. We have seen this in the recent process that led to the abolition of Limited Merits Review.

The key to consumers having confidence around the regulatory regime is transparency. Consumers effectively enter into a social contract with the AER. To be sustainable consumers agree to pay an efficient risk adjusted price and networks make an acceptable equity return.

EUAA members looking at their electricity and gas bills do not see they are getting their end of this social contract. In some cases, it may be due to factors outside of network regulation, but the perception is that network regulation is a major factor.

The development of a binding rate of return guideline is an important contribution to restoring consumer confidence in that social contract.

The importance of the concurrent work on profitability measures

A key part of the consumers' social contract in network regulation is that we agree to pay an efficient price for a network that meets the relevant reliability standards. It is not just an academic exercise of ensuring that all the components of the WACC calculation reflect the latest academic research and available data. It is also a matter of whether the actual profits achieved compare with the allowable WACC.

We recognise the difficulty in comparisons and that is why the EUAA welcomed the current AER review on profitability measures. Consumers need to have confidence that the application of the rate of return binding guideline will give a result that reflects our expectations under the social contract. We understand that the incentive based regulatory structure can bring actual profitability above the Allowed Rate of Return Objective (ARORO) and consumers share in these benefits. However, consumers consider it is a poor argument simply to state that "there are many reasons for actual profitability to be above the ARORO so we should not be worried about actual profitability".

The onus of proof is on the AER and the networks to develop agreed profitability measures to provide a "sense check" on ARORO. This transparency is central to perception that their social contract is being met. We do not have that transparency now.

The AER should help manage expectations about the impact of a binding rate of return guideline

The building block approach used by the AER means that a large proportion of a network's annual revenue cap varies little from year to year and consumers have only limited influence over how much annual prices might change. Return of capital through depreciation is substantially driven by past investment and the RAB. Operating costs may fall due to efficiencies, but much is effectively fixed. Currently the taxation allowance is built on a formula driven by the factors including the benchmark gearing level.

A fall in market interest rates has been the major driver of the lower rate of increase in network charges over recent years, not actions taken by the networks. Even with major change in the WACC variables, it is very unlikely that WACC would fall, ceteris paribus, by more than say 0.5-1.0%. Yet this fall can be quickly swamped by a rise in interest rates.

Reform of the WACC guideline will not "solve" the electricity and gas affordability issue that is so concerning all consumers, but it could make an important contribution to those levers that consumers can have some influence over. We think the AER has an important role – part of the transparency requirement discussed above – to inform consumers about the sensitivity of changes in the various WACC components that it is seeking to focus on, for network revenues and prices.

The AER may appear conservative in its methodology

So much of the debate around WACC comes when the AER is required to make a point estimate of a variable when the data suggests a range eg the varying data sources for market risk premium and beta used to calculate return on equity. While the robustness of these data sources varies and this can influence the selection of the range, it does seem to the EUAA that in the case of variable like market risk premium and beta, the AER has selected a point estimate at the upper lend of that range. This decision serves to result in a higher cost of equity. We look forward to the AER's analysis of the current data sources and expert opinion to assist consumers to understand the basis of the point estimates.

We expect that with the removal of Limited Merits Review appeals and a binding guideline, the AER will be confident in the exercise of its discretion in these estimates.

What appear to be the major issues for the review?

Given the support for the incremental approach proposed by the AER, at this stage the EUAA generally agree with the "higher priorities" proposed in the Issues Paper (pp8-9), though we would give more emphasis to:

1. Examination of the risks networks face and whether the market risk premium and beta accurately reflect that risk allocation – confidence in the regulatory regime requires transparency around the evidence used to arrive at a rate of return that appropriately compensates networks for the risk they bear – and the risk that they pass on to consumers
2. The continued application of the 60/40 debt/equity benchmark
3. Measure of market risk premium and beta

and how to measure these variables given the lack of listed entities on which to benchmark regulated network monopolies against.
This may be amended as a result of a review of the submissions on the Issues Paper.

Andrew Richards

CEO

18th December 2017

Attachment – Response to the AER's Specific Questions

Question 1

In your view, to what extent has the current approach to setting the allowed rate of return achieved the National Electricity Objective (NEO) and National Gas Objective (NGO), the Allowed Rate of Return Objective (ARORO), and the related revenue and pricing principles (RPPs)?

Response

The response of our members, based on the network price path they have faced in their businesses over the last decade, is definitely no.

Now they do not know the nuances of the regulatory structure that may be brought to bear by those who would argue otherwise. But what they have seen over the last decade of significantly increasing network prices is a regulatory structure that:

- gave more importance to networks receiving what they sought as their required rate of return to make the investments they said were required to meet reliability standards
- resulted in huge capital investments being made in gold plated networks with excess capacity
- gave the networks a guaranteed return on an asset base that is increased by inflation each year
- saw network bear very limited business, financial and regulatory risk
- gave insufficient attention to whether this capital was spent efficiently and whether consumers actually were willing to pay those amounts for the increase in reliability
- provided networks with an incentive to spend significant funds in successfully appealing the AER decisions to further increase their almost guaranteed revenues.

Even if the question about the "current approach" is referring to the period since the introduction of the 2013 Guideline, our members still see:

- many networks still maintaining high levels of capex
- networks putting up barriers to the AER's application of benchmarking to network operating costs when our members are subject to market competitive forces both domestically and internationally for their products
- many networks continuing to argue at every reset against the application of the 2013 Guidelines when the message to our members to get their support for the consumer consultation around the Better Regulation process was that the Guideline would reduce this debate
- some networks continuing to spend significant funds in appealing AER decisions
- claims by networks that CPI price increases are "good news' when they are coming off a very high base and our members are not able to pass on CPI increases in the prices for their own products
- where prices have fallen it has been primarily due to a fall in the market interest rate component of the WACC, not something the networks have done to reduce their prices
- reliability has been improved but consumers have had little input into a process around whether or not they are prepared to pay for that reliability; networks seem more interested in their own estimates of the value of customer reliability to justify additional capex than in actually asking consumers how much we value reliability

We note that the AER in the Issues Paper concluded that (p.8):

> "Our view is the allowed rates of return we have set when applying the current Guideline have achieved the national electricity and gas objectives, as well as the allowed rate of return objective."

but provided little evidence for this proposition. Later in the Issues Paper in response to the question that consumers raised at the pre-issue paper forum “if you are planning to use the current approach as a starting point, how do you know if your current approach is working?”, the AER noted (p.15):

> “This is an important question, yet it is difficult to come to a definitive answer.”

As we note below, the lack of agreed profitability measures is a major reason for this lack of consumer confidence.

Question 2

Should information on profitability, asset sales, financeability and any other financial information be used when assessing outcomes against the NEO and NGO, ARORO, and the related RPPs? If so, how?

Response

Yes. As noted above, the key to consumer confidence in the regulatory structure is transparency. The social contract consumers enter into with the networks and the AER is that the regulation will not result in monopoly behaviour and profits.

Our main disappointment is around timing – that little information from the concurrent review of network profitability may be available to input into this WACC process. This is one reason for recommendation above for the change in emphasis in the May 2018 paper.

The experience in developing agreed measures on network benchmarking suggest it may take some years to get alignment on what the measures of profitability should be. Then the debate will be around what factors contributed to the profitability above the allowed WACC. The message we currently hear from the AER is that there are many other factors eg incentive schemes, unregulated parts of the business etc that may explain why profitability is higher than WACC and RAB multiples are > 1. Yes, a profitability measure of 8% compared with a WACC of 7% may be explained by these factors. However, a profitability of 12% is probably not and raises legitimate questions around the WACC calculation.

We return again to the fundamental proposition underlying the social contract consumers have entered into with monopoly network regulation – we need transparency around what is happening. Conclusions are being drawn on both sides of the debate without the required data. We look forward to the AER providing what light it can to this matter given the review timetable.

Question 3

Is the current approach to setting the benchmark term and level of gearing appropriate?

Response

The EUAA supports the concept of a benchmark gearing level. However, we are unsure of what the AER means when it says (p.18):

> “…we do not intend to conduct an extensive review into our approach to setting the benchmark level of gearing.”

We consider that selection of that level to be one of the key issues for this review. We look forward to the AER explaining:

- how to get this market data given the limited sample size eg listed entities that are a combination of regulated and unregulated operations and the relevance of overseas data

- why this limited data set should be considered “efficient”
- why the benchmark level should not be changed given the RAB’s in recent asset sales suggesting gearing levels of above 80% rather that the current 60% benchmark

These problems suggest the current approach may be of limited use and that other methods should be developed to test the current approach. This would involve a more fundamental consideration of the risk allocation between networks and consumers. Currently network bear few business risks eg consumers bear demand and stranded asset risk and few financial risks eg debt costs are passed through and default risk for customers is very small.

While the EUAA recognises that the regulatory structure is independent of ownership, we note:

- how Government owned networks seem to have an equity base much smaller than the benchmark 40% and then get the benefits of the AER benchmark
- the role of government ownership (eg NSW Government’s minority position in some NSW networks) and international government ownership of other networks; while there are no explicit guarantees form these government entities, it may implicitly influence the network’s gearing ratio and cost of debt.

Question 4

Should the conditions and process for setting averaging periods be refined?

Response

We support the AER’s approach in this matter. We agree it “…should be a straightforward, mechanistic process.”(p.19).

Question 5

To what extent are changes required to our current approach of transitioning from an on-the-day rate to a trailing average?

Response

We do not believe any change is required to the current approach of a trailing average with an NPV neutral 10 year transition.

Question 6

Is it appropriate for us to review the return on debt implementation approach by performing a review of the four third party debt data series currently available to us? Please also explain if you think there is further valuing in broadening this scope of debt implementation issues and why you hold this view?

Response

We agree with the proposed AER approach.

Question 7

Would a more prescriptive approach to setting the equity risk premium be appropriate? If the Guideline has a more prescriptive approach to estimating equity risk premium, what set of conditions for reopening the Guideline would best achieve the national gas and electricity objectives and the allowed rate of return objective?

Question 8

Is the theory underlying the Black CAPM still appropriate for informing an equity beta point estimate? In its place, should alternative information to guide the selection of an equity beta point estimate?

Response

The EUAA considers the determination of the equity risk premium is a key matter for this review. As noted above, the perception consumers have is that they are bearing significant risk while the networks are receiving a very high, almost guaranteed minimum return of ~6% real over the next 5 years with very stable cash flows. Our members would happily accept this level of risk adjusted return on an asset base that is escalated by inflation every year.

We support the AER in exploring the merits of changing their approach to setting MRP and equity beta. We believe there is benefit in the AER doing some bottom up analysis around the risk allocation between networks and consumers to give the transparency around the calculation of the appropriate MRP. It will be interesting to see if that analysis suggests a different risk profile between electricity and gas networks.

We support the issues raised in the Energy Consumers Australia submission around the application of the AER's approach to developing range of values and then the selection of the point estimate for MRP and beta. There do seems to be inconsistencies around the recommendations of their advisors and the selection of point estimates by the AER.

We support the investigation of a "stable" equity risk premium that would be applied in a mechanistic way for all determinations and the development of triggers for the early review of this premium.

Question 9

What is the appropriate role of dividend growth models (DGMs) in setting the allowed return on equity?

Response

We agree with the AER's proposed review of the role of DGMs in setting the MRP. We are sceptical of the level of explanatory power the networks seem to give them.

Question 10

Is it appropriate to limit the review of the valuation of imputation credits to updating the empirical analysis? Are there any particular issues we should take into account when updating empirical analysis?

Response

This is consistent with the AER's incremental approach to this review. The value of gamma has been subject to extensive litigation over recent years and the matter should be regarded as settled following recent Federal Court decisions.

While the ENA seems to support the concept of an incremental approach, they seem to be proposing not just an update based on empirical evidence but also a review of which data sources should be used eg for measuring the utilisation rate, which could be regarded as an effective re-opening of issues that were comprehensively considered in the recent litigation. So it seems while the ENA supports an "incremental" approach, they have a wider definition of "incremental".

This ENA approach has the risk that other stakeholders will seek to introduce other matters as well –with the result being an effective re-litigation of the issue. For example, why should consumers pay a higher network price for the decision by networks to source equity outside Australia when there are funding sources within Australia eg super funds that would welcome the opportunity of receiving fully franked dividends, increasing the utilisation rate? This is aside from the matter of the evidence suggesting the level of taxation paid by the networks is lower that the building block allowance.

We support the AER's proposed approach to update the empirical analysis to inform the gamma estimate.

Question 11

Should expected inflation and its interaction with the allowed rate of return be a priority under the Guideline review?

Response

We agree with the AER that issues around the measurement of expected inflation should not form part of this review. They have been extensively debated in the concurrent review of expected inflation.