**Rate of Return Issues Paper**

**Submission by Grattan Institute**

**Introduction**

This submission is in response to the Issues Paper from the Australian Energy Regulator (AER) published in December, 2012. It reflects the issues raised by that paper, includes reference to the summary of meeting from the Rate of Return Forum No. 1, and is primarily informed by Grattan Institute’s report: *Putting the customer back in front: How to make electricity cheaper.* This report was published in December 2012, and is available on the Grattan Institute website at http://grattan.edu.au/publications/reports/post/putting-the-customer-back-in-front-how-to-make-electricity-prices-cheaper/

**General Comments**

Grattan Institute’s research is informed by an analytical approach to the evidence. In our Report, we concluded that the monopoly electricity distribution businesses have been making unduly high profits, given the relatively low risks they face. In our view, the risk/return balance is central to the question of rate of return for these businesses. Whilst we did identify other major issues that need to be addressed, in the context of this submission we recommended relatively conservative changes that would have meant a net benefit to consumers of $2 billion over the current five-year regulatory period. If no changes are made, and similar circumstances apply in coming years, the opportunity for similar savings – of around $390 million a year – will be lost.

We have recommended that the regulator uses its updated powers under the proposed changes to the National Electricity Rules to:

* Estimate the allowed rate of return for equity taking into account prevailing market conditions for equity funds and observed returns for a range of companies. This would be consistent with the AEMC’s recent change to the NER, developed in response to proposals by energy user groups. If distributors continue to earn higher-than-expected equity returns, these powers should be used to apply parameters that strike a better balance between investment risk and consumer prices than currently exists.
* Implement a cost of debt approach that is more likely to reflect a benchmark efficient distributor’s actual financing costs by incorporating a moving average of benchmark debt rates. Again, this approach would be consistent with the AEMC’s proposed changes to the National Electricity Rules, in particular the allowance for the use of historical moving averages and the direction to the AER to take note of the significant differences between the allowed return and the debt servicing costs of a benchmark-efficient distributor.

The full analysis that supports our conclusions and describes these recommendations is in our Report, and we will not simply repeat the analysis in this submission. The final general comment we make is that our specific recommendations relate to the equity beta applied by the AER and on the debt side to over-compensation for actual cost of debt, long-term “lock-in” of costs of debt and related party debt.

In terms of implementation, we support the AER’s need to move to practical changes that can be implemented in a real world environment and we understand this was a key agreement at the Rate of Return Forum No. 1. In that sense, for example, a change in equity beta that we have recommended is not a theoretically perfect answer, but rather a shift towards the interests of consumers, and, by definition, away from the interests of the owners of the businesses. In our view, the analogy with steering a large ship is useful, in that adjustments in steering followed by assessment of the results before further adjustments is likely to lead to a safe arrival. Our analysis indicates that moving the inputs in a predictable manner based on monitored publicly available outputs (ie actual rate of return) is likely to be the best approach.

**Specific answers**

Question 1

The principles are generally framed in a way that is sound and difficult to reject. For example, incomprehensible and inaccessible methodologies are hardly likely to be supported. It is less clear how the principles will inform the AER’s determinations.

Question 3

The question of predictability versus flexibility is a false trade-off. We need both. There is much said and written in regard to certainty for investors, and this is a matter closely related to the risk/return balance. For each of the parameters, the AER decisions should be predictable in the way in which it responds to energy market circumstances. The approach should be similar to that of the Reserve Bank in which it has widely communicated outcome parameters such as an inflation band, and it’s flexibility in the way it adjusts its input parameters can be reasonably well predicted by stakeholders. Therefore, if the AER had clearly communicated target outcomes that would be used in setting input parameters such as equity beta, industry would be able to undertake its own planning with the appropriate level of confidence in the risks it would be facing.

Question 4

As implied in the response to Question 3, a pre-determined approach should be taken to mean a clear set of rules and guidelines by which the AER will make its decisions and exercise regulatory judgement.

Question 5

In approaching the question of efficient financing strategies and costs, we are mindful of the moral hazard issue. We agree with the views reported on this issue from the Forum in regard to a standalone entity with particular notice however of parent company structures and arrangements. This issue is expanded more in regard to relate-party debt in our Report. We assume that the suggested approach is that a business that takes on a level of risk that subsequently delivers negative financial consequences should not be compensated by consumers for that decision. Equally, businesses that manage such risks to deliver better than benchmark results should also benefit from the consequences.

Questions 9-13

The AER should consult widely in coming to a view on the benchmark efficient entity, including against businesses across a wide range of sectors. Grattan Institute’s analysis in our Report was an initial attempt in this direction.

Question 15

As indicated above, judgement as to the appropriate overall rate of return should be based on the actual outcomes delivered against a basket of businesses, and considered as an output against which input parameters are adjusted in a predictable fashion.

Questions 16-19

Whilst we recognise concerns with the CAPM model, we would support its use with the suggested application of regulatory judgement rather than trying to identify a theoretically superior model. Consistent with our other comments, the emphasis should be on predictable responses by the AER to emerging or changing market circumstances.

Questions 20-22

With the caveats previously noted in regard to moral hazard and related-party debt, the regulatory approach to cost of debt should reflect the practices by which efficient businesses maintain a portfolio of borrowings with different terms and interests rates. Following a detailed analysis of debt costs across the businesses, we concluded that the use of a published cost of debt parameter such as the ten-year Bloomberg BBB Fair Value Curve would be a significant improvement over the current approach, and would have delivered significant savings over the current five-regulatory period. We recognise that there may be other, preferable such parameters that would be satisfactory in this regard.

Although the question of ownership has not been raised in the Issues paper, we note that it was addressed in the Forum. On that subject, we would agree with the view that risks for the businesses can be considered similar across ownership models provided that the governance structures between government owners and their businesses and the competitive neutrality fees are applied appropriately. There is at least anecdotal evidence that this may not always have been the case.