INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

26 September 2018

Mr Warwick Anderson
General Manager
Australian Energy Regulator
GPO Box 520 Melbourne Vic 3001

Via email: [redacted]

Dear Mr Anderson

Submission to the AER on the review of the draft rate of return guideline

Infrastructure Partnerships Australia is pleased to respond with this submission to the Australian Energy Regulator (AER) on the draft decision regarding the review of the rate of return guideline for energy networks.

Regulatory frameworks for energy network businesses have experienced several years of substantial change and uncertainty. As an overarching comment, our key concerns stem from the absence of an agreed policy direction to help guide the proposed amendments.

Infrastructure Partnerships Australia has made several submissions in relation to the economic regulation of energy networks and we attach the following for additional context:

- Submission to the AER on the Consultation Paper – Initial Report on the review of the regulatory tax approach (7 August 2018)
- Submission to the AER on the review of the regulatory tax approach (5 June 2018)
- Submission to the COAG Energy Council on the proposed binding rate of return amendments (18 April 2018)
- Submission to the Senate Standing Committee on Environment and Communications on the Abolition of the LMR Regime (22 September 2017)
- Submission to the Minister for Energy on the Review of the LMR Regime (16 March 2017), and
- Submission to the COAG Energy Council on the Review of the LMR Regime (2 October 2016).

In this submission, we have focused our comments on the below points:

- the AER's draft guideline should consider the impact that short-term price relief will have on future consumers, and
- the long-term economic and consumer risks posed by a rate of return determination that is too low.

From the outset, we submit that the AER's current proposal may lead to a regulated rate of return that is too low to provide the appropriate incentives for efficient investment in energy networks.

Recommendations

Before publishing a final decision on the rate of return guideline, the AER should:

1. Undertake a detailed risk assessment of the long-term impact on price and service outcomes of setting a methodology which results in a rate of return that is significantly lower than the efficient level, and
2. Publish an explanation of how the final guideline supports the achievement of the National Electricity Objective (NEO) and National Gas Objective (NGO) as recommended by the Independent Panel report released on 7 September 2018.

The draft guideline should consider future consumers, not just the consumers of today

We note the AER's recognition that, in setting the regulated rate of return to promote the long-term interests of consumers, it faces two investment-related risks:

> 'A rate of return that is too high may encourage over investment, while a rate of return that is too low may encourage under investment. Over-investment may not be in the long-term interests of consumers with respect to price. Under-investment may not be in the long-term interests of consumers with respect to quality of service' (AER July 2018 Explanatory Statement, p.72).

We also note the AER's emphasis on 'having regard to the views of consumer groups' on rate of return parameter values, as well as to empirical estimates of parameter values (AER July 2018 Explanatory Statement, p.83). However, where these views are not based on an empirically robust estimation or other evidence needed to reach a sound estimate of parameter values, this approach does not constitute a credible process for discharging the AER's responsibility to consider the 'long-term interests of consumers'. On this topic we note that the Consumer Reference Group's nominated equity beta estimates have fallen outside of the AER's identified potential range of credible values.

We submit that, to a large extent, the AER's approach must not amount to just asking today's consumers what they think about today's final energy charges. If given the option of lower charges today, with no consideration of long-term consequences, consumers will generally be supportive of

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policy that reduces prices in the short-term. In the current political context, this imposes a downward bias on the rate of return determination process and disregards the interests of future consumers.

We note that the AER is aware of the potential impact that short-term consumer bias may have on future energy networks:

> 'We acknowledge that this review is being undertaken in an environment of heightened consumer concern about increasing energy costs and relatively large (and sometimes underutilised) investment in regulated assets bases over recent years. While the rate of return is an important contributor to network prices, there are other network and non-network costs that also contribute to overall energy prices. <u>Nonetheless, we are cognisant of the effect that higher energy prices may have on the willingness of consumers to pay for further improvements in network reliability</u>' (AER July 2018 Explanatory Statement, p.82-3, underlining added).

The AER acknowledges that it is likely consumer views may preference short-term price relief, at the expense of consumer needs over the long-term. However, it is unclear whether the AER has made allowances for this bias in drafting the rate of return guideline. As such, it appears that consumer consultation has imposed a downward bias on the rate of return guideline process; a bias which could impose additional price and service costs on consumers over the long-term.

Setting the rate of return too low poses a risk to long-term economic and consumer interests

A rate of return that inhibits ongoing investment in energy networks poses a major risk to achieving the NEO and NGO. The AER should seek to avoid this threat, given that appropriate investment in networks has the potential to significantly reduce costs for consumers. For example, the Australian Energy Market Operator's (AEMO) Integrated System Plan estimates that investment in new transmission infrastructure could reduce system costs by $1.2 billion compared to a no 'new build' scenario (AEMO Integrated System Plan, July 2018, p.5).

The key rate of return parameters cannot be estimated with precision. Recognising this, the AER has selected point estimates from within the plausible range of empirical estimates. To date, its selections appear not to have impaired investment incentives severely.

The AER's current proposal is to select lower values, notwithstanding the fact that:

- previously adopted values remain within the plausible range of empirical estimates
- recent market evidence, using the AER's own analytical approaches, supports parameters that would lead to increases in return on equity, rather than a large decrease, and
- technological developments, including the continued spread of distributed generation, have increased the risks of investing in energy networks.

We regard this move from values that have been working satisfactorily from an investment perspective, to lower values that may inhibit investment, as an unnecessary risk.

Furthermore, we note the Independent Panel's advice that the trade-off between risk and cost requires further examination prior to the release of the final guideline and support the recommendation that:

> 'The AER should explain more clearly how the Final Guidelines promote the achievement of the national gas and electricity objectives' (Independent Panel Review of the AER's Rate of Return Guidelines, September 2018, p.V).

Conclusion

As Australia's peak infrastructure body, representing public and private infrastructure owners and operators, we are pleased to contribute to this consultation process and respectfully request that the impacts of the proposed rate of return guideline be carefully considered within the long-term context of the energy market.

Security, price and reliability of energy supplies are best addressed by promoting efficient investments and that means investors must have confidence the price setting regime is fair and well-defined. Moreover, efficient investment in networks will be crucial in supporting the energy sector's broader transition both in terms of new policies and new technology.

Thank you for your consideration of this submission. If you require further detail please contact Lydia Robertson, Senior Policy Adviser, on [redacted] or [redacted].

Yours sincerely

[redacted]

Adrian Dwyer
Chief Executive Officer