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Paula Conboy
Chair
Australian Energy Regulator

Review of the Rate of Return Guideline Review

Dear Ms ~~Conboy~~, Paula,

I am pleased to provide Energy Consumers Australia's response to the Issues Paper for the Review of the Rate of Return Guideline.

While the Rules require the regular review of the Guideline, this review is being conducted at a critical juncture for Australian households and small businesses. The Guideline applies to both gas access arrangements and electricity network revenue determinations, but it is the latter that has been receiving the most public scrutiny.

The Energy Security Board in its first *Health of the NEM* report has observed:

> *The National Electricity Market (NEM) is not in the best of health. The immediate symptoms are a power system where reliability risks are increasing, electricity bills are not affordable, and future carbon emissions policy is uncertain.*

Affordability has been of such concern that the Australian Government has referred the electricity retail and supply industries to the Australian Competition and Consumer Commission (ACCC) for a price inquiry. The ACCC's Preliminary Report identifies network costs as the largest component of retail bills and the increase in network costs as the largest contributor to increased retail prices.

The ACCC has also noted the increase in the aggregate value of the Regulated Asset Base of the networks, and has contemplated writing down these assets, saying:

> *We should examine ways to reduce the existing network costs embedded in the system. For example, the Finkel Review found that consideration should be given to writing down asset values, either voluntarily or compulsorily, where appropriate. Such a write-down may be appropriate where it can be determined that over-investment has occurred or where assets become stranded.*

The increase in network costs was also the basis for the decision of the Minister for the Environment and Energy, the Hon Josh Frydenberg, supported by the majority of jurisdictions, to abolish Limited Merits Review. In conjunction with that decision, the Council of Australian Governments Energy Council (COAG Energy Council) is proceeding to legislate to make the new Rate of Return Guideline binding on revenue determinations and access agreements.

While this focus on affordability is important, in making the new Guideline the Australian Energy Regulator (AER) is required to make its decision in such a way as to promote the National Electricity Objective and the National Gas Objective. These both seek outcomes that are in the long term interests of consumers.

Stripped away from theory the long term interests of consumers is served by current and future consumers paying no more than they need to for reliable supply. The twin goals of low prices and sustainable network businesses are not competing goals; they both need to be delivered.

In our submission we note that the out-turn profitability of networks is a central consideration in assessing how well the existing guideline is delivering on the objectives. On current timing, the AER's related work on profitability will not be available to inform this review.

I cannot impress upon you enough the importance of accelerating this work in the current climate.

On the evidence otherwise available to us we conclude that the existing guideline is likely to be resulting in systematic over-compensation of networks. The ongoing evidence that networks have a bias to choose capital expenditure over operating expenditure is evidence that the returns on capital are in excess of the cost of capital faced by the network providers.

Reducing the Rate of Return to more accurately reflect providers' cost of capital will help reduce this bias to capital expenditure and may also obviate the need for asset write-downs being contemplated by the ACCC and other stakeholders.

Reducing the Rate of Return would also help secure for networks their critical role in the new market as the platform for new energy services. Expensive networks will distort he efficient and coherent transformation of the National Electricity Market.

We have identified the two key settings that we believe contribute to this outcome; the estimate of gearing and the estimate of the equity risk premium (both its components – the market risk premium and beta – are set too high).

Finally, I note that the AER is taking an 'an incremental approach' to this review. Energy Consumers Australia agrees that there are a number of elements of the Guideline that have been subject to multiple reviews and we agree that the outcome of those reviews needs to be considered.

However, our analysis suggests that there is benefit of a broader review of the Guideline that may also contemplate some further changes to the Rules. We believe that the AER should use this review to identify any outstanding issues that cannot be addressed within the Rules for a further review to start at the conclusion of this review.

We look forward to ongoing participation in the review through 2018.

Yours sincerely,

Rosemary Sinclair
Chief Executive Officer