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Response to AER statement on IEEFA report on electricity network profits

22 November 2023. In its report *Power prices can be fairer and more affordable*, IEEFA reviewed the Australian Energy Regulator (AER)'s productivity and performance analysis and demonstrated that supernormal profits cannot be explained by productivity improvements. In the AER's statement on the IEEFA report, the AER has so far not provided any new evidence to support its assertion that about $10 billion of additional network profits – on top of about $16 billion of allowed profit – is consistent with incentive regulation and has no impact on consumer bills. The AER's critique of the IEEFA report is not based on evidence and logic.

The AER states among other things that:

> *We derive a similar outcome to IEEFA with a return on equity of $9.7 billion out of total revenue of $122 billion ($2022, real). The difference is that our estimate uses the actual leverage of the networks businesses as opposed to average gearing across networks used by IEEFA.*

This is the first time that AER has acknowledged the size of the dollar figure gap between allowed and actual network profits. IEEFA acknowledged in its report that the AER did not disclose leverage data for each network and only provided IEEFA with weighted average leverage data for each year. The AER does not set out the derivation of its estimate and IEEFA cannot test whether the AER estimate is 'like for like' with the IEEFA estimate.

The AER asserts that the gap between actual and allowed returns of ~$10 billion is *'consistent with the National Electricity Law (NEL) and National Energy Objective (NEO)*' because the *'regulatory framework reward[s] networks for 'improving productivity and service performance beyond benchmarks'.* It asserts that productivity improvement benefits exceed higher profits and therefore do not affect consumer bills. It concludes that the difference between the allowed and actual return on equity is "outperformance" not supernormal profits.

As shown in the AER's own productivity indices, reproduced below, distribution and transmission sector productivity improvements between 2014 and 2021 left productivity well below the levels in 2006.[1] Productivity for distribution in 2014 is ~89% of the level in 2006, a decline of 11%. The improvement over the seven years between 2014 and 2021 was around 3%, leaving a net decline of around 8% from 2006.

[1] Note that the total factor productivity (TFP) index used by the AER includes performance including reliability, as well as efficiency of expenditure efficiency.

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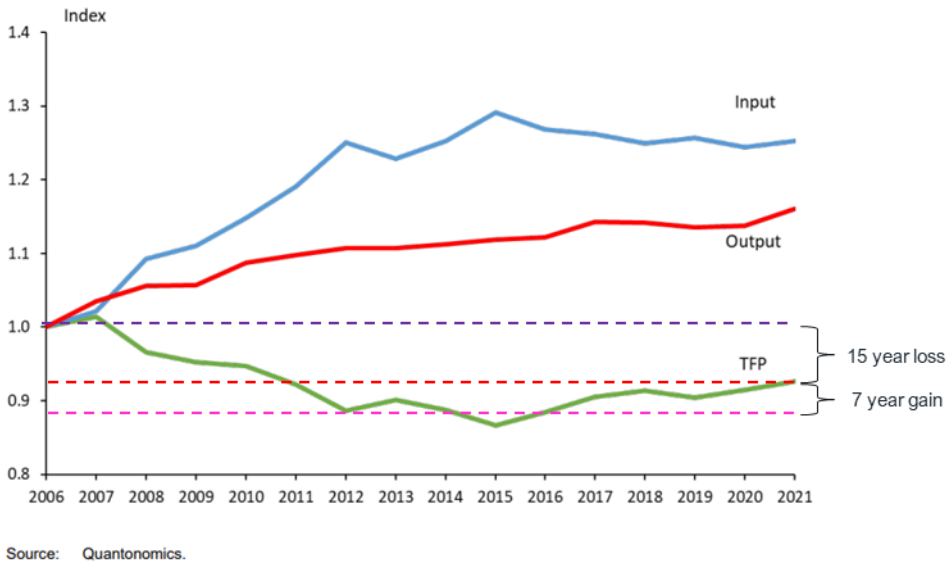
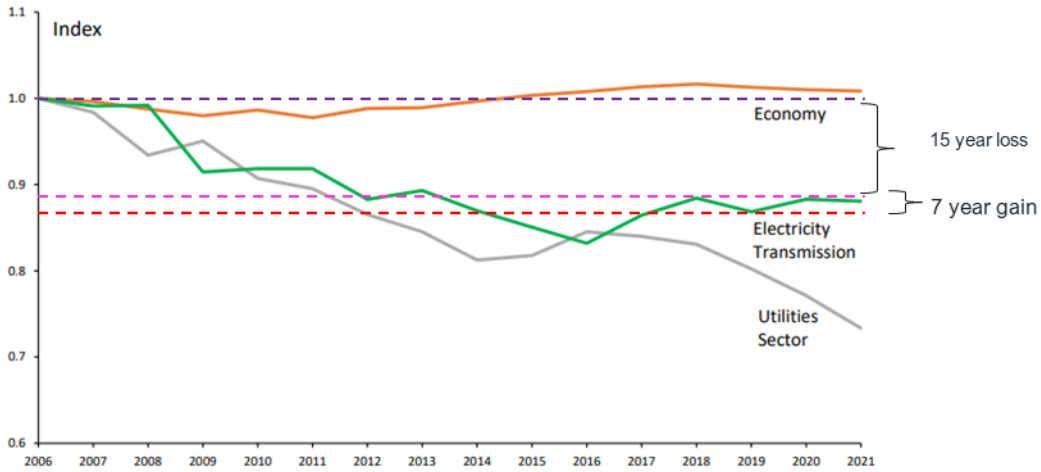
Figure 5 Industry-level distribution input, output and TFP indices, 2006–2021



Source: Figure 5, 2022 Annual Benchmarking Report – Distribution Network Service Providers, AER, November 2022

Similarly, transmission sector productivity in 2021 was still ~11% lower than in 2006, though there has been some improvement since 2014.

Figure 1 Electricity transmission, utility sector, and economy TFP, 2006–21



Source: Figure 1, 2022 Annual Benchmarking Report – Transmission Network Service Providers, AER, November 2022

The AER position on rewarding productivity is self-contradictory – it argues that networks should be rewarded for modest productivity improvements since 2014, but that consumers should not be compensated for the much higher declines in productivity between 2006 and 2021.

Drilling down to productivity and supernormal profits for each network, the figure below is reproduced from Figure 15 of IEEFA's report *Power prices can be fairer and more affordable*

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(November 2023). This shows that the relationship between productivity and performance under incentive regulation, represented by the diagonal purple arrow, does not correspond to the AER's own productivity benchmarking for each network for each profitability reporting period between 2014 and 2020. There should be very few cases where networks with <85% productivity scores should be able to extract supernormal profits, but analysis of AER data tells a different story.

Source: IEEFA

Even if sector-wide productivity had improved since 2006, it does not follow that a long-term gap of 70% between allowed and actual profits is reasonable. Drawing on expert advice from the Australian Competition and Consumer Commission (ACCC) in 2018[2], IEEFA suggests that, due to reasonable regulator under-estimation of productivity gains (information rents), a distribution of profit multiples between 0.9 and 1.3 could be expected under incentive regulation.

On this benchmark, network "outperformance" is clearly excessive. As shown in the IEEFA report, over 162 reporting entities and periods, more than 60% of the differences between actual and allowed profits exceeded a multiple of 1.3 – i.e. actual profits being 30% above allowed profits. On average, actual profits were 1.7 times the allowed profits. If the AER's figure of $9.7 billion is correct, more than 50% of outcomes would exceed the 1.3 times benchmark.

The reference in the AER statement to consumers receiving 70% to 80% of of the benefits of reductions in expenditure ignores the contribution to supernormal profits from differences between allowed and actual expenditure. As explained on page 26 of the IEEFA report, the 2023 AER review of incentives schemes did not acknowledge the persistence and size of "outperformance". Therefore the conclusions drawn, in IEEFA's view, do not appear valid, including the finding that consumers receive 70% to 80% of expenditure reductions.

[2] Darryl Biggar. Understanding the role of RAB multiples in regulatory processes. 20 February 2018.

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In standard economic usage, the term “supernormal profits” encompasses the concept that more productive and innovative firms can earn profits that are higher than the industry average and the cost of capital, adding economic or “surplus” value.[3] Whether referred to as “supernormal profits” or “outperformance,” it is clear from both the IEEFA analysis and the AER’s response that networks are receiving significant additional profits of $10-$11 billion above the allowed level, which is around $16 billion. The IEEFA analysis acknowledges that some level of supernormal profit could be reasonable, but objects to such an excessive level of supernormal profits.

[3] For example, see Investopedia: Economic Profit (or Loss): Definition, Formula, and Example.