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Dear Warwick

AER's Draft Position – Inflation Review

Thank you for the opportunity to respond to this consultation. The AER's review of the regulatory treatment of inflation is a critically important review that will determine whether appropriate incentives will be in place to promote efficient investment in Victorian distribution, transmission and gas networks over their next regulatory periods.

The AER's Draft Position includes two changes to the inflation estimation approach – the adoption of a 5-year term and applying a symmetrical glidepath to 2.5% by the 5th year. We recognise that the AER's draft position is a material shift from its existing approach which brings the inflation estimate closer towards the expectations of investors (which we consider can be most directly observed from market data).

It is essential that the changes provided for in the Draft Position are applied immediately, with no transition, to the Victorian electricity distribution determinations which will be made by 30 April 2021. If this is not done, equity investors in Victorian networks can expect nominal returns of close to 2%[1] to be delivered for the AER's benchmark firm over the 2022-26 regulatory period. This is very materially below the return of 4.59% the AER has determined (in its Draft Decision) is required to attract efficient investment in the network in the long-term interests of customers.

It is in the long-term interests of consumers for prices to reflect the efficient cost of running the network. This includes the efficient rate of return required to attract investment. We note that real returns will fall materially between the current regulatory period for the Victorian DBs, from an average of 3.21% in 2016-20 to an average of 1.94%[2] in 2022-26, even if the inflation methodology proposed in the Draft Position is immediately applied. This translates to a reduction in customer bills of $192m per annum across Victoria (or over $950m over the five-year regulatory period).

By immediately applying the Draft Position approach, the artificial reduction in real returns is avoided ensuring:

[1] Assuming the PTRM expected inflation input of 2.30% while investor/ market expectations are 1.30%. Investors must pay the portion of nominal debt costs which exceed the 'return on' cash building block allowance.

[2] Assumes a risk-free rate of 0.80% and expected inflation of 1.95%.

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- More appropriate incentives for efficient investment are provided; and
- Customers do not receive short term price reductions at the expense of theirs and future customers' long-term interests, because of distortions to efficient investment signals.

AusNet Services supports and relies upon the ENA's submission to this review.

Inflation Estimation Approach

Why a 5-year term should be adopted

Lally has advised the AER that *'given that the AER's regulatory cycle is five years, the NPV=0 principle implies that the AER ought to be estimating expected inflation over each of the next five years rather than over the next ten years.'*

AusNet Services agrees that the term of the inflation estimate is most appropriately set by the roll forward model, rather than the term of either debt or equity set out in the Rate of Return Instrument. The purpose of expected inflation is to remove from 5-year revenues the amount that will be added onto the RAB through indexation over that 5-year period. Therefore, the term of this estimate is not conceptually or mathematically linked to the term of either component of the rate of return.

We also note that there is not currently a mathematical relationship between the debt benchmark term of 10 years and the term of the inflation estimate. As the return on debt is calculated using a trailing average, at the start of the regulatory period the inflation estimate is subtracted from the nominal portfolio debt return, which is based on an average of annual debt observations with remaining terms of between 1 and 10 years. As under the current approach the term of the estimate (10 years) is not linked to the portfolio term of debt, a move to 5 years does not undermine any consistency in this position.

Why a 10-year estimate with a glidepath is not appropriate

The AER's current approach to setting inflation expectations assumes inflation returns to 2.5% (the mid-point of the RBA's target band) from the third year of the estimate onwards. In its Draft Position, the AER has appropriately revised this assumption in response to a lack of evidence supporting this expectation. Instead, the draft position now assumes inflation will return to 2.5% by year 5, with a glide path applied from the RBA's short-term inflation forecast at year 2 up to year 5.

While introducing a glidepath is an improvement on the current methodology, without the change to term also occurring, this is an insufficient change to deliver an unbiased forecast of actual inflation and to fix the current problem. We are not aware of any evidence that indicates inflation will return to 2.5% in year 5. In particular:

- Market data (inflation swaps and breakeven inflation) indicates inflation is expected to be materially below 2.5% in year 5, with current 5 year inflation swaps sitting at around 1.6%,
- Deloitte, the AER's own experts, expect inflation to be well below 2.50%, at 2.20%[3], in FY25.

[3] DAE Wage escalator report – implied inflation forecasts, report for AER xx 2020

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Therefore, if adopting a glidepath is the only change to be made, expected inflation will remain at an inappropriately high level in the AER's upcoming decisions.

The AER's Proposed Approach is Not Unbiased

As presented in ENA's submission, the RBA's second year inflation forecast has over-estimated actual inflation for a decade. This is strong evidence that the use of the RBA's short-term forecasts is likely to overstate expected inflation going forward. We note that inflation swaps have not exhibited such bias. As the inflation input into the PTRM should match, in expectation, the inflation that will be put into the RAB through indexation within the regulatory period, this highly relevant evidence of a persistent bias suggests that the heavy reliance on the short term RBA forecasts will not achieve the nominal rate of return over the forthcoming regulatory period.

Indeed, the Governor of the RBA recently stated that due to high levels of current uncertainty, the RBA will be placing more weight on **actual** than on **forecast** inflation[4]. It would be prudent for the AER to also have regard to actual inflation when assessing the merits of its approach.

Therefore, although the AER's proposed approach is a material improvement on its current approach, it is still expected to overestimate inflation and under-deliver the efficient nominal rate of return.

A Transition Must Not be Applied

There are a number compelling reasons that support adopting the AER's new inflation methodology at that the earliest opportunity.

Applying a transition will extend existing 'windfall losses' for investors

In the 2016-20 regulatory period, the impact of the overestimate of inflation in AusNet Services' 2015 Decision has resulted in revenues being $111m lower than an accurate inflation forecast would have produced because the deduction from revenues has not matched the actual indexation to the RAB. If the AER had applied the industry's proposed market-based measure (breakeven inflation) it would have reduced this gap to $25m but still resulted in windfall gains for customers.

This meant investor returns were $111m below that required to deliver the efficient nominal return set by the AER for 2016-20. While we recognise that the AER targets an ex ante real return, it is important context that the starting point of the AER's new more accurate approach is after a regulatory period where investors have already sustained a very material loss. These circumstances do not, therefore, justify a transition on the basis of fairness.

In addition, because lagged inflation is applied when rolling forward the RAB, short term RBA inflation forecasts are available for the RAB indexation for the first three of the five years of the 2022-26 regulatory period (Dec 2020, Dec 2021 and Dec 2022 forecasts from the August MPS). As confirmed in the Draft Position Paper, the AER considers the RBA's forecasts remain the 'best estimates of short term expected inflation', and for this reason, continues to use its forecasts in its approach. The chart below shows that the forecasts used to roll forward the RAB are currently at either 1.00% or 1.25% for years 1-3 of the next regulatory period.

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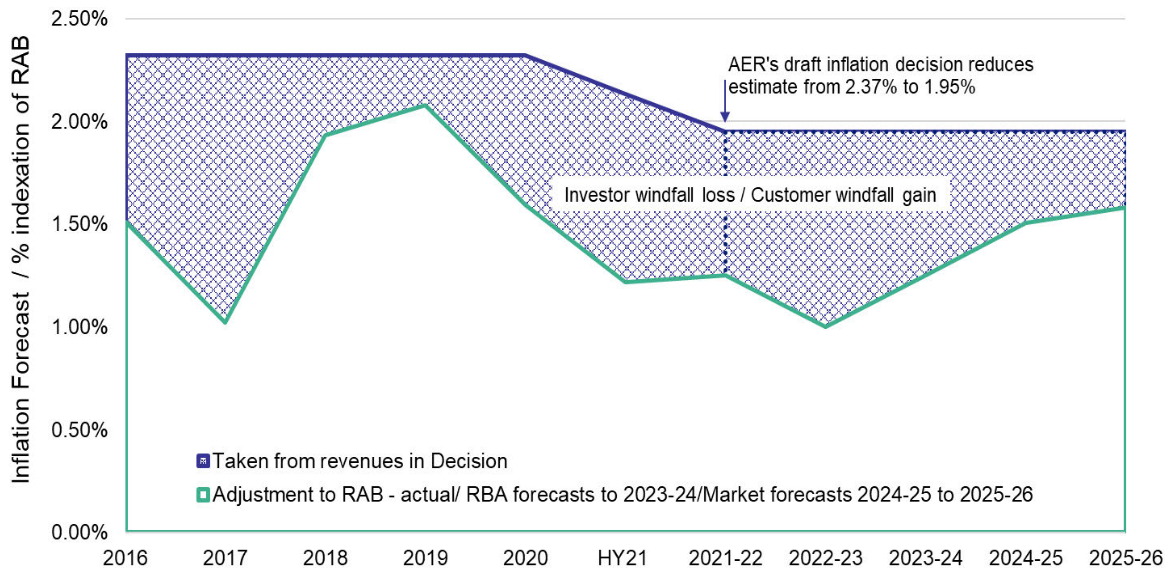
[4] Philip Lowe, RBA Governor, 15 October 2020

The outcome of using the RBA's forecast to index the RAB for the 2022-26 regulatory period is shown in the figure below (green line), with the impact of the shift in the AER's draft inflation decision on expected inflation also shown by the movement form the unbroken line to the dotted blue line.

Figure 1: Expected Inflation and Expected RAB Indexation for Victorian Distributors



The disparity between the AER's current and proposed inflation approaches and actual inflation used for RAB indexation is startling. Even if the RBA's short-term forecasts are accurate and inflation returns to 2.5% for both years 4 and 5 of the regulatory period the 5-year inflation expectation would be 1.70%; which is significantly below the 1.95% implied by the AER's Draft Position. For AusNet Services, this represents a shortfall of approximately $40m over the 2022-26 regulatory period. While we recognise the framework aims to deliver the nominal rate of return in expectation, based on the above it is difficult see how investors could expect to receive the allowed nominal rate of return in the 2022-26 period.

Correcting a known bias and improving a forecast methodology immediately by applying the AER's Draft Position in the Victorian decisions cannot be construed as a windfall by any reasonable independent observer. Rather, its immediate application simply takes us slightly closer to an unbiased ex ante expectation that the nominal rate of return allowed by the AER for 2022-26 will be delivered while still leaving customers with substantial windfall gains.

There is no compelling case for a transition

The Draft Position identifies several advantages of immediately moving to the new inflation estimation methodology.[5] For the reasons explained above, we agree not only that these advantages exist but that the proper performance by the AER of its economic regulatory functions or powers requires it to act to realise these benefits.

The Draft Position also raises the possibility that there may be advantages to having a transition. However, the advantages identified are speculative. Describing them as outcomes that 'should'

[5] AER, *Regulatory treatment of inflation, Draft position*, October 2020, 69.

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or 'may' occur indicates there is a question about whether a transition will realise the advantage claimed. In the absence of clear evidence showing that a transition will better contribute to the achievement of the NEO and the NGO, the AER is required to implement its new methodology immediately.

AusNet Services is cautious about using transitions to new regulatory methodologies as a matter of course. We acknowledge the AER's decision to adopt a staged transition for its return on debt calculations from an 'on-the-day' to a trailing average approach. However, this is distinguishable from the present case on the basis that the staged transition was supported by evidence showing how networks' actual debt-financing practices would change in response to the change in the AER's approach. That is the transition in that case actually prevented windfall gains or losses. This has been borne out subsequently. In contrast, transitioning an improvement of the inflation forecasting methodology does not change industry practices and would exacerbates windfall gains and losses, not mitigate them.

In addition, a change in approach from estimating a 10-year, to a 5-year, term should not be thought of as 'breaking' a series and therefore warrant a transition. The 10-year expectation only ever applied for a 5-year regulatory period and was then 'broken' and a new 10-year expectation applied for the next 5 years. As the 10-year inflation expectation is not applied across multiple regulatory periods; but rather is reset every 5 years; there is no need for a transition as the application of an entirely new estimate would occur under both the status quo and the AER's Draft Decision, with the relevant question being which estimate is the most appropriate.

The case for adopting a transition in the present case is not supported by evidence or theory, or required to allow a change in financing practice. Therefore, the AER must transition to the new approach promptly. Failure to do this will prolong the use and deleterious effects of using a methodology that is no longer fit for purpose and does not best contribute to the achievement of the NEO and NGO.

Customers benefit when there are efficient incentives for network investment

The regulatory regime has been designed to ensure that networks are able to attract efficient levels of capital to invest at levels which promote the long-term interests of consumers. The AER sets the efficient rate of return required to achieve this. The estimation of an unbiased expectation of future inflation determine whether the efficient nominal rate of return estimated by the AER is ultimately delivered by the regime.

Under the current approach there is not an ex ante expectation that the efficient rate of return will be delivered. This should be a concern to customers as this is not in their long-term interests. Underinvestment will result in lower levels of service, and over the long-run, higher costs to address this. This was established at the initiation of the regulatory framework.

While, unlike expenditure determinations, the price-service trade-off is in some ways less direct, if the regime is not delivering a reasonable rate of return it will result in underinvestment and future customers experiencing deteriorated services and having to pay more than would otherwise be efficient.

In addition, the combination of the historically low risk-free rate and the current approach to forecasting inflation has severe impacts on cash flows, delivering negative NPAT for the benchmark entity. Over time this can be expected to lead to credit rating downgrades, which will result in an increase in the efficient financing costs required to provide network services.

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Therefore, it is not in the long-term interests of customers to slow the immediate shift to an improved less biased inflation expectation.

Applying a transition is not consistent with the National Electricity Rules

As the AER notes[6], the Revenue and Pricing Principles require it to provide a network business with a reasonable opportunity to recover at least the efficient costs it incurs in providing direction control network services and comply with regulatory obligations or requirements or making a regulatory payment.[7] The Draft Position intimates that the opportunity for recovery can be over the life of the asset:[8]

> *We consider a method to estimate expected inflation that achieves the following properties is likely to be capable of achieving the NEO and NGO:*
>
> - *It results in correct ex-ante compensation over the life of the assets (i.e. cash flows with a present value equal to the total value of investment in the RAB over the life of the assets)…*
> - *It results in an efficient allocation of risk*

This position is inconsistent with the language of the Revenue and Pricing Principles and the policy objectives of the regulatory framework. The Principles require that a network be given a 'reasonable' opportunity to recover at least its efficient costs. It is not reasonable to spread recovery of estimated inflation over multiple periods where there are acceptable methodologies available that allow inflation to be appropriately estimated to achieve an unbiased ex ante expectation that the efficient nominal rate of return will be delivered during a single regulatory period. Further, to achieve an NPV=0 principle over multiple regulatory periods necessarily requires that there are periods where inflation is over-recovered and others where it is under-recovered. This is inconsistent with the AER's obligation to derive a 'best estimate' of inflation and, therefore, it cannot knowingly make a decision that is biased.

In addition, as explained in Section 10.1 of the AER's Draft Position paper, where a 10-year expectation of inflation is removed from revenues it may not match RAB indexation over the 5-year regulatory period. Where RBA short-term inflation forecasts included in the expectation below 2.5%, even if outturn inflation perfectly matched the AER's inflation expectations in every year of the regulatory period, the RAB indexation would be below the revenue reduction for inflation – resulting in a lower nominal return than determined to be efficient by the AER. As the RBA's short term forecasts are currently materially below 2.5%, retaining a term greater than 5 years in the Victorian determinations will create a bias such that there will not be an ex ante expectation that the efficient nominal return set by the AER will be delivered.

Should the framework target a nominal return?

AusNet Services remains of the view that a move to a hybrid framework – which targets a nominal return on debt while continuing to target a real return on equity – would minimise risk to both customers and investors by avoiding over/ under payment and over/ under-compensation for efficient debt costs. This would be a preferable outcome for both parties and permanently remove any incentive by any party to over or underestimate inflation for 60% of the rate of return.

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[6] AER, *Regulatory treatment of inflation, Draft position*, October 2020, 26
[7] National Electricity Law, section 7A(2). See also National Gas Law, section 24(2).
[8] AER, *Regulatory treatment of inflation, Draft position*, October 2020, 28-29.

In the Draft Position the AER indicates it would prefer a nominal framework rather than a hybrid. However, we note that some investors value the inflation protection of the RAB delivered by the current regime. There seems to be a less compelling case for targeting a nominal return on equity (a move to a nominal framework) than there is for moving to a nominal return on debt.

Please contact Charlotte Eddy, Manager Economic Regulation, on [redacted] with any questions in relation to this submission.

Sincerely,

Tom Hallam
General Manager Regulation
AusNet Services