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6 November 2020

Mr Warwick Anderson
General Manager, Networks Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

By email: InflationReview2020@aer.gov.au
Cc: [redacted]

Dear Mr Anderson

Re: Response to 2020 Inflation Review – Draft position

Thank you for the opportunity to respond to the AER's Draft position – regulatory treatment of inflation[1] (Draft Decision) dated October 2020.

We endorse the Energy Network Association's (ENA) submission on this matter, which provides a detailed response to the issues raised in the AER's Draft Decision, although:

> we accept the AER's position to retain the Reserve Bank of Australia's (RBA) short-term forecasts the first two years of the estimation period. We acknowledge, however that consideration of market data could balance the upward bias in the RBA's short-term forecast, and

> we propose a modification to the end-point of the glide-path to achieve better alignment with market expectations.

The remainder of this submission sets out our views on the AER's Draft Decision.

Estimation methodology

The AER's current approach to estimating expected inflation is to calculate a ten year geometric average using the RBA published headline rate forecast for the first two years and the mid-point of the RBA target inflation band of 2.5 per cent for years three to ten.

The AER's Draft Decision sets out two changes to its existing approach, being to:

> reduce the current estimation period from ten to five years in order to match the length of the regulatory period, and

> apply a linear glide-path from the RBA's forecasts of inflation from year two to the mid-point of RBA inflation target band (i.e. 2.5 per cent) from year three to year five.

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[1] Found at Link

We welcome these changes, which improve the likelihood of the forecast methodology reflecting market expectations of inflation compared to the current approach. In particular, we agree with the AER that a five year estimation term:

> better enables changes in market conditions and expectations to be captured in the forecast, and

> better matches the expected value of indexation of the regulatory asset base (RAB)[2] in the next regulatory period with the indexation deducted from the building block revenue in the current regulatory period. This increases the likelihood of Network Service Providers (NSP) being able to achieve a real rate of return commensurate with the determined regulated return.

We accept that market expectations of inflation in the short term align with the RBA's published short-term forecasts. Further, whilst in the past longer term market expectations of inflation may have been anchored to the mid-point of the RBA's target range, recent statements from the RBA Governor suggest that the mid-point of the RBA's target range, 2.5 per cent, no longer represents a solid anchor for inflationary expectations, especially over the AER's proposed averaging period of five years.

The RBA has indicated that it does not expect inflation to return to the target range of 2 to 3 per cent for three years and further that employment, not inflation, is currently the primary focus of monetary policy.[3] Accordingly, anchoring longer term inflationary expectations to 2.5 per cent, even allowing for the use of a glide-path, is still likely to overestimate inflation in the current market conditions. We note swap markets at the end of September 2020 suggest market expectations of inflation for the next five years to be 1.61[4] per cent, compared with 1.95 per cent as suggested in AER's Draft Decision.

A better alignment with market expectations could be achieved if the end-point of the glide-path better reflected the current stated position of monetary policy. It seems reasonable that the RBA will allow inflation to increase until it is within the previous target band, especially if unemployment persists above the level suggested by the Treasurer as being acceptable, namely 5.5 per cent[5]. Absent a clear statement by the RBA to the contrary, monetary policy can be expected to be focused on reducing inflation if it exceeds the upper end of the range, namely 3 per cent. Outcomes within the range would be expected to invoke a neutral policy response from the RBA.

Therefore, a glide-path might be profiled such that if the RBA's short term forecast of inflation in year 2 is:

> below 2 per cent, then the end point of the glide-path is the lower bound of RBA band (2 per cent)

> above 3 per cent, then the end point of the glide-path is the upper bound of RBA band (3 per cent), and

> between 2 and 3 per cent, then the end point is the mid-point of the RBA band (2.5 per cent).

This proposal recognises that inflation could track well above or well below the mid-point of the RBA's target range for an extended period. Further, this approach would satisfy the AER's criteria for the glide-path, being:

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[2] In accordance with clause S6A.2.4(c)(4) of the NER, at the end of the regulatory period, our actual RAB is rolled forward using actual CPI over the regulatory period. This means that if forecast inflation (used to make a negative adjustment to our building block revenue) is higher than actual inflation used to index our actual RAB, then our revenue is reduced by more than the actual RAB is increased, leaving an under recovery (and vice versa). Forecast inflation in our 2018-23 Revenue Determination is 2.45 per cent p.a. whereas actual inflation is currently much lower than this.

[3] Philip Lowe, Governor, RBA, 15 October 2020.

[4] Bloomberg – the five year inflation swap as at 30 September 2020. The five year interest rate swap is 0.296 per cent as at 30 September 2020

[5] Budget 2020–21 - Budget Overview, p.6. See Link.

> symmetrical over time – this would avoid any estimation bias over the long term[6], and

> enduring – so that it provides a 'robust method that can be used regardless of wide-reaching events or disturbances to market data'[7]. It is acknowledged that, in the event there was a fundamental restating of monetary policy, then this approach to determining the end point of the glide-path might need to be revisited, but this is no different to the issues created by the current approach.

We agree with the AER that if a better estimate of inflation is available and not adopted, efficient investment in, and use of, energy networks is not promoted and the contrary is likely to occur, which cannot easily be corrected given the long lives of network assets. We also agree with the AER that this would not be in the long-term interests of consumers because any short term advantage of lower prices would undermine efficient investment in the long term so that services are not delivered in a safe and reliable way.

Transition to the new approach

The AER's Draft Decision seeks views on whether the change to the five year inflation term should be introduced immediately or delayed[8]. We support the immediate adoption of a forecast methodology that is expected to provide the best estimate of inflation because:

> the National Electricity Law (NEL), National Electricity Rules (NER) and the National Electricity Objective (NEO) require the AER to adopt the best estimate of inflation and provide NSPs a reasonable opportunity to recover at least the efficient cost of providing their services

> it does not introduce windfall gains and losses in future periods without removing the gain or loss that has occurred in the past period

> it is consistent with the AER's approach to updating other ex-ante forward looking cost estimates, and

> it would promote efficient investment, which is in the long-term interests of consumers.

Recent AER decisions have seen significant inefficient windfall gains to consumers and losses to NSPs as the forecast of expected inflation has been significantly above market expectations. For example, in our 2018-23 Revenue Determination, the AER estimated inflation to be 2.45 per cent. However, if the AER's improved methodology was adopted, the inflation forecast would have been 2.35 per cent.[9] This reduced our revenue by $39 million (Real $2017-18) over the current regulatory period,[10] which is needed to meet our efficient costs.

The AER has previously applied transition arrangements for other parameters, such as the trailing average cost of debt[11]. It did this because:

> a change in the estimate of forecast efficient costs was backward looking, incorporated past estimates and provided an opportunity to introduce bias into historical averaging periods

> the immediate adoption would result in windfall gains or losses, and

> future costs would continue based on actions taken in the past to adopt the prior approach.

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6 AER Draft Decision, pp. 60-61

7 AER Draft Decision, pp. 61

8 AER Draft Decision, p. 70

9 This was calculated by applying the AER's improved methodology to the inflation forecasts in the RBA's February 2018 statement on monetary policy to June 2019 (2.25%) and June 2020 (2.25%), with a linear transition to 2.5% by year five.

10 This value is the change in allowed building block revenues, in Real $2017-18, which arises over the 2018-23 period if forecast inflation of 2.35% were used instead of 2.45%. This was calculated using the latest version of the TransGrid PTRM for the 2018-23 period published by the AER.

11 AER, Final Decision, Power and Water Corporation, Distr bution Determination 2019-2024, Attachment 3, Return on debt transition, April 2019, p. 3-6.

In the case of the forecast of expected inflation:

> the estimate is forward looking and the change in method does not include past estimates or enable bias in historical averaging periods that impact the forecast
> a transition would result in a windfall gain or loss being the difference between the forecast of inflation the AER adopts in its decision and its best estimate of expected inflation, and
> market expectations (and costs incurred) in past periods do not affect market expectations (or costs to be incurred) in future periods.

We also note that adopting a transition to a better estimate of efficient costs is not consistent with other AER decisions on forward looking efficient costs by the AER, such as the regulatory approach to tax, productivity, and the regulated return.

A transition should only be applied in an unbiased and symmetrical manner consistent with a stated set of principles and past decisions. Further, it should be aimed at avoiding future windfall gains or losses and not continue windfall gains or losses from past periods (as would be the case here).

A best estimate of inflation is required to give effect to the current RORI and to maintain the real value of the RAB in the roll-forward model. Therefore, there is no reason to delay the adoption of the best estimate until a new RORI is established or expectations of inflation coincidentally match the current method.

Furthermore, there is no impact on customers of adopting the best estimate of inflation but there would be an impact if an inferior estimate were adopted. This impact would be a windfall gain to customers, a windfall loss to investors in the form of a return less than the efficient return set out in the RORI, and consequentially inefficient levels of investment that are likely to impact services in the longer term.

Changes to the regulatory framework

We accept that the AER considers a rule change by the Australian Energy Market Commission (AEMC)[12] is required to introduce either:

> a hybrid regime, which involves targeting a nominal return on debt and real return on equity[13], or
> a nominal regime, which involves a nominal rate of return unadjusted for actual inflation. This regime therefore does not require an estimate of expected inflation.

We consider that further consideration of these issues can occur outside of, and independent of, the AER's decision on the methodology to be adopted to produce the best estimate of inflation.

As outlined in our submission on the AER's Discussion Paper[14], investment must be financeable in order for us to undertake our share of the Major Projects required under the Australian Energy Market Operator's (AEMO) Integrated System Plan (ISP). This requires revenues in the early years of these projects to better match the investment needs, in order to support achieving the benchmark credit rating of BBB+ and gearing of 60 per cent (i.e. 60:40 debt to equity) that the AER assumes in its 2018 RORI.

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12 AER Draft Decision, p. 71

13 The ENA's proposed hybrid approach would involve a change to the Roll forward model reflect a 40 per cent weighting to actual inflation (for the equity component of the RAB) and 60 per cent weight to forecast inflation (for the debt component of the RAB) which is the same inflation assumption used in the post-tax revenue model (PTRM).

14 TransGrid, Response to 2020 Inflation Review – Discussion Paper, 3 August 2020, p.2. See Link

As discussed above, improvements to the AER's approach to forecasting expected inflation will reduce revenue under-recovery[15], which is consistent with providing NSPs a reasonable opportunity to recover their efficient costs of investment. However, it will not address the timing of revenue recovery and therefore the financeability of Major ISP Projects.

We have submitted a rule change proposal to the AEMC to remove the requirement to index the RAB for Major ISP Projects (i.e. a 'nominal regime') to address this issue (Financeability Rule change). Removing the requirement to index the RAB would result in a revenue profile that better matches the timing of when costs are incurred.[16] The AER's Decision Paper acknowledges a nominal regime has the advantage of 'not requiring a best estimate of expected inflation' and is 'used by other monopoly regulators'. It also includes a comparison of the real, nominal and 'hybrid' approaches which raises issues that may be relevant to our Financeability Rule change. We do not find the comparison provides a clear outcome in terms of the benefits or preferred approach. However, we note that the purchasing power for consumers is not necessarily preserved under the real approach because the forecast indexation deducted from revenue can result in a permanent gain or loss where the forecast of expected inflation differs to the expected inflation to be applied to the RAB.

The Financeability Rule change is primarily aimed at improving the profile of revenue to better match the revenue required to achieve financing requirements. However, it also removes the risk that the AER's forecast of expected inflation deducted from nominal returns differs from market expectations of inflation. The impact of this is to reduce the return below that set out in the RORI and potentially result in negative cash returns.[17] If the Financeability Rule Change is not approved, and the AER continues to overestimate expected inflation, the financeability of Major ISP Projects will deteriorate further.

We do not consider it is in the long-term interests of consumers for either NSPs or consumers not to be able to secure the efficient funding necessary to deliver Major ISP Projects, or for them to earn a return below the regulated return, especially in the current environment with very low inflation and inflation expectations. As outlined by the AER, this could lead to inefficient levels of investment that impact negatively on the services delivered in the long term.

In our circumstances, removing indexation from the RAB provides a market benefit that significantly outweighs the issues raised by the AER about a nominal approach because it is required to secure finance for these projects.

We consider that investment in Major ISP Projects – and therefore our Rule change proposal – is in the long-term interests of consumers because it is integral to achieving AEMO's optimal development path, which will:

- strengthen the National Electricity Market (NEM), and
- deliver gross market benefits of $11 billion in net present value (NPV) terms in its central scenario, with potentially higher benefits if the NEM moves quickly towards a renewable future.

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[15] Arising from the difference between the amount of indexation deducted from building block revenue and the amount added to the RAB when expected inflation is higher than actual inflation (and vice versa)

[16] This would support us maintaining our current credit rating is Baa2, which is equivalent to an S&P credit rating of BBB, however, would not allow us to achieve the benchmark credit rating and gearing assumptions in the AER's 2018 Rate of Return Instrument

[17] AER Draft Decision, pp.88-89

Next steps

We look forward to continuing to work with the AER as it finalises its review of the regulatory treatment of inflation to arrive at an outcome in the long-term interests of investors and consumers. If you have any questions on this letter, please contact our Head of Regulation, Stephanie McDougall, on [redacted] or [redacted].

Yours sincerely

[redacted]

Jason Conroy
Chief Financial Officer

TransGrid