AUSTRALIAN ENERGY REGULATOR

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7 November 2019

Sandeep Kumar
Manager, Regulatory Analysis and Strategy
Jemena
PO Box 16182
MELBOURNE VIC 3000

Dear Sandeep

Re: Response to model consultation - Inflation compensation

Thank you for your letter dated 20 September 2019 in relation to our preliminary consultation on the development of gas financial models. I write in response to the section of your letter that requested changes to our treatment of inflation and suggested that we should target delivery of a nominal return on debt.

As you note in your letter, the AER's current inflation approach targets the delivery of a real rate of return on capital plus outturn inflation. The real rate of return is derived from the nominal return on capital less expected inflation. We currently use what we refer to as the 'RBA approach' to estimate expected inflation, combining the RBA's short term inflation forecasts (for years 1 and 2) and the mid-point of the RBA target band (i.e. 2.5 per cent) for years 3 to 10, taking a geometric average across the 10 yearly figures.

We most recently concluded that we should maintain this inflation compensation approach in December 2017, after a comprehensive review. We examined whether the AER should target the delivery of a real return on capital, a nominal return on capital, or a hybrid approach that targets a nominal return on debt and real return on equity. This was 'Issue 2' in that review. We decided to maintain the existing target—that is, the delivery of a real return on capital plus outturn inflation. There was broad stakeholder agreement that the regulatory models delivered this rate of return target.

Changing the inflation compensation target would be a substantial change to the regulatory framework. Jemena's letter sets out a view that service providers are 'being undercompensated relative to the nominal return' when actual inflation is below forecast inflation. We do not agree that there is under compensation when using an approach that targets the real (not nominal) rate of return on capital. Nominal revenue will be lower in a low inflation environment (and higher in a high inflation environment), but this preserves real revenue outcomes and investors receive a revenue allowance with the same purchasing power as initially targeted.

In developing the gas financial models we have started with the existing electricity models, and are considering whether there are any gas specific amendments required. The treatment of inflation is not a gas specific issue. As noted in our 2017 review, we consider it is important to preserve a consistent inflation approach across gas and electricity in order to prevent investment distortions across the sectors.

There has been constructive engagement with a broad set of network, investor, retailer and consumer representatives through the working group on expected inflation and low CGS yields. In our view, the appropriate forum to continue to explore the matters raised in your letter is through that working group. The working group can also consider material from other stakeholders, such as the material we expect to receive from the ENA, and allow stakeholders to discuss the implications of this material.

We remain focused on achieving outcomes that are in the long term interest of consumers. This includes the provision of a regulated rate of return that will provide an incentive for efficient investment in energy networks. We acknowledge that, in an environment of low interest rates and low bond yields, it is important that we carefully monitor our regulatory approach and we will continue to do so.

If you have any questions, please contact Kenny Yap on [redacted] or via [redacted].

Yours sincerely

[redacted]

Scott Haig
General Manager (acting), Networks Finance and Reporting
Australian Energy Regulator

Sent by email on: 07.11.2019