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5 November 2020

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

Lodged via email: InflationReview2020@aer.gov.au

Dear Mr Anderson

Re: Review of expected inflation 2020 – Draft position paper

Thank you for the opportunity to respond to the Australian Energy Regulator's (AER) draft position paper on the regulatory treatment of inflation published in October 2020. Our detailed response to the AER's draft position is set out in Attachment 1.

Overarching comments

ATCO acknowledges that the proposed five-year glide path method improves the estimate of inflation included in nominal rates of return when compared to the previous method. However, ATCO continues to support the use of a market-based measure of expected inflation.

ATCO continues to encourage the AER, in consultation with policy makers, consumers and other stakeholders, to develop a roadmap towards the full adoption of a nominal modelling approach. We believe that a considered transition to full nominal modelling is in the long-term interest of consumers. It will ensure the required investment to move to a low emissions energy future and continued safe and reliable provision of services.

Since our last submission, more focus has been given to the benefits of nominal modelling through the Transgrid rule change lodged with the AEMC. In addition, our last submission included detailed advice from Dr Jeff Makholm on the economic efficiency of nominal modelling.

Furthermore, ATCO supports the Energy Networks Association's (ENA) submission made in response to the Discussion Paper.

About ATCO

ATCO has been proudly operating in Australia and providing employment opportunities for almost 60 years. ATCO is a customer-focussed global company that develops, builds, owns and operates a range of energy infrastructure assets, supporting residential, business and commercial consumers. ATCO is committed to investing in its people, innovation and technology to drive leading-edge application-based research.

In Australia, ATCO:

- owns and maintains the largest (Mid-West and South-West) gas distribution network in Western Australia, together with two non-regulated gas distribution networks in Albany (LPG) and Kalgoorlie (natural gas), servicing over 760,000 connections through more than 14,000 km of natural gas pipelines and associated infrastructure;
- owns an exempt retailer (Source Energy Co.) in the Wholesale Electricity Market that provides electricity to around 500 embedded network customers in strata developments through a combination of solar photovoltaic systems, grid purchases and battery storage;
- owns and operates two power generation facilities (a joint-owned facility in Adelaide and a wholly-owned facility in Karratha) with a combined capacity of 266 MW;
- is drawing on its established expertise in natural gas to explore the future role of hydrogen through a number of projects, including the Clean Energy Innovation Hub (an embedded hybrid microgrid system that incorporates renewable solar generation, battery storage, natural gas backup generation and blends green hydrogen produced with natural gas used onsite), are working in collaboration with Fortescue Metals Group to establish a hydrogen refuelling facility at the Hub, and are currently conducting a feasibility study into the development of a commercial scale renewable hydrogen production facility (Clean Energy Innovation Park); and
- manufactures and delivers modular building solutions to a diverse group of customers.

ATCO's Australian businesses are part of the worldwide ATCO Group with approximately 6,500 employees and assets of $22 billion. ATCO is a diversified holding corporation with investments in Structures & Logistics (workforce housing, innovative modular facilities, construction, site support services, and logistics and operations management), Energy infrastructure (electricity generation, transmission and distribution; natural gas transmission, distribution and infrastructure development; energy storage and industrial water solutions; and electricity and natural gas retail sales), Transportation (ports and transportation logistics) and Commercial Real Estate.

If you have any questions or would like to discuss any of these matters further please contact me or Hugh Smith, General Manager, Regulation and Corporate Affairs.

Yours sincerely

[redacted]

John Ivulich
Chief Financial Officer

Attachment 1: ATCO Submission

ATTACHMENT 1: ATCO SUBMISSION ON AER INFLATION REVIEW DRAFT POSITION

05/11/2020

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1. INTRODUCTION

ATCO welcomes the opportunity to provide a submission on the Australian Energy Regulator's (AER) 2020 Inflation Review draft position.

This document details ATCO's submission in response to the matters detailed in the Draft Position Paper. In preparing this submission, we have considered the unique circumstances that apply to gas distribution networks and the requirements of the National Gas Rules as well as the impact on consumers.

ATCO's response to the AER's draft position is summarised as follows:

- **Clarity -** Additional clarity is needed on how regulated price determination and annual price adjustment should work, in an inflationary environment, to contribute to achievement of the objectives of the national energy laws.
- **Market based measures -** ATCO continues to support the use of a market-based measure of inflation.
- **Nominal modelling -** ATCO encourages the AER, in consultation with policy makers and other stakeholders to develop a roadmap towards the full adoption of a nominal approach to setting Network Service Provider (NSP) revenue (i.e. no indexation of the RAB).

ATCO supports the separate submission the Energy Networks Association (ENA) has lodged in response to the Draft Position Paper.

2. HOW SHOULD REGULATED PRICE DETERMINATION AND ANNUAL PRICE ADJUSTMENT WORK, IN AN INFLATIONARY ENVIRONMENT?

In response to the AER's discussion paper APA raised the following question:

> *"…before proceeding, the question of how regulated price determination and annual price adjustment should work, in an inflationary environment, to contribute to achievement of the objectives of the national energy laws, must be addressed. Only when this question has been answered can we answer more specific questions about the best methods of estimating expected inflation, including the best approach to dealing with inflation expectations in the trailing average return on debt."*[1]

After a review of the AER's draft position paper, consultation paper and subsequent submissions it appears there is consensus regarding:

- Service providers should be able to recover efficient financing costs;
- Financing risk is best borne by the service provider, not consumers;
- Actions should be in the long term interests of consumers; and
- The framework used should promote efficient investment in, operation and use of the networks.

There also appears to be a universal recognition that no matter the revenue model used, and acknowledging we are using forecasts, there will be imperfections in the result.

The setting of service provider revenues and the resultant access charges must be interpreted in the context of the national gas objective (NGO) and the revenue and pricing principles (RPP) which set the objectives to:

- promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers; and
- allow a service provider to be provided with a reasonable opportunity to recover at least the efficient costs of providing reference services.

Imprecisions in the revenue model due to estimation or simplification[2] do not invalidate the model provided these objectives are promoted. The corollary is that if the revenue model does not promote these objectives, it is not fit for purpose in the context of the National Gas Law (NGL).

[1] APA Group, APA submission on regulatory treatment of inflation, 29 July 2020, pg. 3, Available from: https://www.aer.gov.au/system/files/APA%20-%20Submission%20to%20discussion%20paper%20-%202020%20inflation%20review%20-%20July%202020.pdf

[2] For example, first year effect", the use of lagged inflation or the rate of return being set for five years for equity rather than being matched to the cost of funds in each year over an access arrangement period

3. MEASURING INFLATION IN THE PTRM RFM FRAMEWORK – USE MARKET BASED MEASURES

ATCO acknowledges the proposed five-year glide path method improves the estimate of inflation when compared to the previous method and reduces the mismatch between inflation deducted from revenue and inflation added back to the RAB.

Before proceeding, it is important to clarify our understanding of the role of the estimate of inflation in the PTRM RFM framework. ATCO notes the AER's conclusion in its Draft Position Paper that regulatory inflation is set to ensure that what is taken out of allowed revenues in the PTRM is equal to what is expected to be put back in via RAB indexation in the RFM.[3] Actual inflation is added back to the RAB based on the actual inflation in the 5 year access arrangement period. Therefore, regulatory inflation should be estimated for the same five year period. Consistent with the NGO and RPP, matching what is taken out of revenue to what is added back to the RAB ensures the service provider is allowed a reasonable opportunity to recover at least the efficient financing costs. Distortions caused by the difference between forecast inflation and actual inflation are minimised.

It is important to note this estimate of inflation has no relevance to the return estimated under the rate of return instrument (RoRI). It is simply a matter of matching what is taken out of revenue to what is added back to the RAB to keep the service provider whole for the cost of funds determined via the RoRI.

However, ATCO considers that market based estimates are a better estimate of inflation used in the deduction of inflation from revenues than the RBA forecast of inflation used in the proposed glide path. Market based estimates have the following benefits:

- **Unbiased forecast:** Market based estimates do not require the use of judgement, resulting in an unbiased forecast that is arrived at on a reasonable basis.
- **Better estimate of year two inflation:** Information presented by the ENA at the AER's inflation review workshop[4] showed market based measures of inflation outperformed the RBA forecast as a measure of inflation in year 2 of the proposed glide path. The inflation measure for year 2 of the glide path is critical to setting the inflation measures in years 3 and 4.
- **RBA 2.5% target for year 5 is unrealistic in the current economic environment:** With the RBA cash rate at 0.1%, and no increase expected for the next three years,[5] the RBA's ability to boost the economy and create inflation is virtually nil. Setting an inflation target of 2.5% in year 5 of the glide path is currently unrealistic. Market measures will set an inflation estimate reflecting current expectations of future inflation.

3.1 Liquid Commonwealth Government Security (CGS) market

The current RBA inflation estimate approach was adopted in response to liquidity issues in the real CGS market. That is no longer the situation. Therefore, the barrier to using a market based estimate of inflation has been removed. The Queensland Treasury Corporation (QTC) in its submission quoted the European Central Bank to demonstrate that liquidity in the market has returned.

3 AER, Draft Position, Regulatory treatment of inflation, October 2020, pg. 48

4 ENA, Review of AER's approach to inflation, Network sector response to AER draft position paper, AER inflation review public forum, 21 October 2020, slide 8.

5 RBA, Statement by Philip Lowe, Governor: Monetary Policy Decision, 3 November 2020, Available from: https://www.rba.gov.au/media-releases/2020/mr-20-28.html

> *'To summarise, unlike in the period immediately following the collapse of Lehman Brothers, markets for inflation protection are currently functioning well and the role of liquidity effects appears limited."*[6]

Similar to the AER, the ERA adopted the Treasury bond implied inflation approach to estimate inflation prior to 2008 but then adopted the RBA method as a result of the impact of the global financial crisis on the liquidity of indexed Commonwealth Government Securities.[7] However, in contrast to the AER, the ERA reverted back to the Treasury bond implied inflation approach once liquidity returned to indexed Commonwealth Government Securities.[8] The Economic Regulation Authority (ERA) responded to changing circumstances to provide the best estimate of inflation.

3.2 Conclusion on best inflation estimate

In conclusion, ATCO considers that market based estimates are a better estimate of inflation. We continue to support the Treasury bond implied inflation approach as adopted by the ERA.

6 European Central Bank, July 2014, Monthly Bulletin, pg.36; Quoted in Queensland Treasury Corporation, Review of the regulatory treatment of inflation, submission to the AER discussion paper, 29 July 2020, pg.33

7 ERA, Final Decision on Proposed Revisions to the Access Arrangement for the South West Interconnected Network, 4 December 2009, para 835-837

8 ERA, Final Decision on Proposed Revisions to the Access Arrangement for the South West Interconnected Network, 5 September 2012, para 1416-1418

4. FRAMEWORK SOLUTION - A NOMINAL MODEL

4.1 Framework Options

Transgrid have identified that there are features of the regulatory framework that have significant implications for the financeability of large scale projects with long asset lives. The financeability issue results from the interaction of the regulatory concepts and revenue modelling that defers revenue recovery primarily through the deduction of expected inflation on the RAB from revenue in the PTRM and the indexation of the Regulatory Asset Base in the RFM. Recently, Transgrid has lodged a rule change with the AEMC that is seeking the adoption of a nominal model.

Discussion during the AER's inflation review focusses on three potential framework options.

- The PTRM RFM framework providing a real rate of return
- A hybrid model with a nominal debt return and real equity return
- A nominal model which pays the efficient cost of funds

The differences between the framework options is how and when the return is received in cash by the investor to meet funding and shareholder commitments (be they debt or equity). There are also differences between the models in the requirements to estimate inflation and overall complexity. These differences, and the impact they have on the long-term interests of consumers, have been highlighted in the Transgrid rule change.

ATCO strongly encourages the AER, in consultation with policy makers, consumers and other stakeholders, to develop a roadmap towards the full adoption of a nominal modelling approach. We believe that a considered transition to full nominal modelling is in the long-term interest of consumers as it will ensure the required investment to move to a low emissions energy future and continued safe and reliable provision of services.

4.2 PTRM RFM framework issues

The AER PTRM RFM framework provides for a nominal return using two mechanisms; through the PTRM allowed revenue, an estimated ex ante real rate of return on the RAB, and through the RFM compensation for actual inflation.

The AER's aim of providing an ex ante real rate of return is to protect the capital value of funds invested. This is achieved in the PTRM framework by adding actual inflation to the RAB, not the expected inflation reflected in the amount deducted from revenue, and so creates an issue in any period of under and over compensation for the cost of funds. By not providing a rate of return which reflects the benchmark efficient cost of funds determined under the RoRI, due to the discrepancy between estimated inflation and actual inflation, efficient investment incentives required under NGL section 24(3) are distorted.

The PTRM and RFM framework creates issues by capitalising the actual inflation component of the return in the RAB because:

- The service provider is not compensated in cash for its actual cost of funds at the time funding costs are incurred which means capital, at a cost, is deployed to fund future costs. This is a cost consumers bear in the long run that they do not otherwise need to bear, creating intergenerational impacts.
- The investor is denied the opportunity to decide for themselves where is the most efficient place to invest their capital, being the inflation component of the return on the RAB. It is not the Regulator's role to make investment decisions for the investor.

The ability of the NSP to meet its funding commitments, be they debt or equity, are compromised both by the potential mismatch of the amount deducted from revenue compared to the amount added back to the RAB and the capitalisation of returns in the RAB. In our view this is contrary to the principle enshrined in the NGL section 23(2) and 23 (2)(a):

> *A service provider should be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in—*
>
> *(a) providing reference services;*

Additionally APA in their submission have noted the impact of this mismatch between deducting expected inflation on the RAB from revenue and adding actual inflation to the RAB is not NPV neutral.[9]

In summary, the PTRM RFM framework fails the test of meeting the twin objectives to:

- promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers; and
- allow a service provider to be provided with a reasonable opportunity to recover at least the efficient costs of providing reference services.

4.3 Nominal model meets requirements

ATCO submits a nominal framework is superior to the PTRM and RFM framework. It allows the service provider a reasonable opportunity to be fairly compensated for its cost of funds and provides efficient investment and network operation incentives consistent with the National Gas Law.

With the nominal model, revenue building blocks are determined by applying a nominal rate of return to an unindexed regulated asset base. Inflation compensation is paid through reference tariffs now rather than in the future. Additionally, costs are allocated period to period on a basis consistent with how costs are incurred including the return on and of capital.

The advantages of a nominal model include:

- **Better value for consumers:** Consumers are better off in NPV terms. Long term absolute dollar costs to consumers are lower. There is an equitable price path.
- **Reduced complexity:** Inflation and real returns do not have to be estimated nor indexation of the RAB calculated.
- **Better investment signals:** NSP's recover efficient financing costs. Cashflows match funding costs. Investment decisions lie correctly with the NSP. Investment and financing risks are correctly allocated to the party that can best manage the risk. Period to period windfall gains and losses to consumers and NSP's are eliminated.

4.3.1 Better value for consumers

The profile of cashflows under the nominal and PTRM RFM frameworks is not equivalent from the average consumer's perspective. Using a home loan mortgage rate as the discount factor for the average consumer, it can be demonstrated that the nominal method is in the long term interests of consumers. For a single $100 million investment consumers are $7.5 million better off under the nominal method assuming a mortgage rate of 3.27%[10] over the illustrative asset life. In principle as long as the consumer's cost of funds, say a home mortgage interest rate, is lower than

9 APA Group, APA submission on regulatory treatment of inflation, 29 July 2020, pg. 1,

10 RBA 30 April 2020: Lending rates; Housing credit; Outstanding; Owner-occupied; Variable-rate; All institutions

the regulated rate of return the consumer is better off under a nominal model where costs to them are not deferred and increased.

The total of bills paid by consumers is higher under the PTRM RFM framework than under the nominal approach. This is because costs to consumers are deferred to future periods under the PTRM RFM framework by capitalising the inflation component of the rate of return in the RAB. This capitalised amount is a cost borne by future consumers, creating intergenerational impacts.

The nature of energy services is being driven by changes in technology and the increased adoption of distributed energy resources (DER), such as battery and solar photovoltaic (PV) systems. ATCO recognises that in light of increasingly competitive off-grid technologies such as solar and batteries, future consumers of distribution networks are no longer captive resulting in a long term flattening and likely decline of demand. The implicit assumption in the PTRM RFM framework of increased demand over time flattening future prices is no longer valid. The increased burden on future consumers due to deferring costs will result in rising prices and an inequitable allocation of current costs to future consumers. A nominal approach provides longevity for the regulatory regime in response to the ever-changing market environment that is in the long-term interests of consumers.

4.3.2 Reduced complexity

In a nominal model, rates of return are based on observed nominal rates of return. This means neither expected inflation nor the target ex-ante real rate of return have to be estimated. The estimation error is eliminated. Additionally, all the discussion, effort and cost around the estimation process is eliminated. Administration costs for the Regulator are reduced. Costs to consumers are reduced. Investors receive a return more aligned with the benchmark efficient cost of funds.

4.3.3 Better investment signals

A nominal model provides better investment signals because the rate of return received equals benchmark efficient financing costs. That is, the rate of return received is the same return a benchmark efficient service provider would use to evaluate investments.

A nominal model provides sufficient cashflows to the business to be financeable. The consequence of capitalising inflation in the RAB is that cashflows that might otherwise be used to meet the cost of funds commitments are not available. The lack of funds to meet contractual debt commitments under the PTRM RFM framework has been discussed at length in other submissions, including the recent Transgrid rule change request. Insufficient cashflows under the PTRM also has implications for dividend policies and implicitly forces the firm to keep on investing in the RAB through inflation indexation. Sapere in their report to the AER make note of the impact of negative cashflows to equity in current conditions forcing dividends to be funded either through depreciation or borrowing. In the former case, a move away from efficient investment in and operation of the network is implied.[11]

Removing the need to estimate expected inflation also ensures that any variation between actual and expected inflation will be truly random. The risk allocation between consumers and network service providers is symmetric. Service providers bearing inflation risk under a nominal model is not a new risk. Under the PTRM RFM framework NSP’s are exposed to two types of inflation risk.

- Variance between actual and expected inflation; and

11 Sapere, Target return and inflation, Input to the AER inflation review 2020, 30 June 2020, para. 141

- Movements in actual inflation – albeit smoothed by capitalisation in the RAB.

Under the nominal model the first disappears. The second may be more volatile but is compensated through the nominal component in the nominal rate of return.

4.4 Conclusion on framework solution

In conclusion, ATCO submits that a considered transition to full nominal modelling is in the long term interests of consumers. ATCO encourages the AER, in consultation with policy makers, consumers and other stakeholders, to develop a roadmap towards the full adoption of a nominal modelling approach.