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Warwick Anderson
General Manager – Network Finance and Reporting
Australian Energy Regulator
Canberra ACT 2602

Dear Warwick

Re: AER's Discussion Paper on the Regulatory Treatment of Inflation

AusNet Services welcomes the opportunity to respond to the AER's Discussion Paper on the Regulatory Treatment of Inflation. We are encouraged that the AER is undertaking this review given the current economic environment means that the current approach to setting expected inflation is no longer viable. While the impacts of regulatory inflation in the regime are complex and technical, it is a critical parameter which determines whether the rate of return determined by the AER is actually delivered. Systemic bias in the approach can jeopardise business sustainability and the ability of networks to maintain credit ratings and attract high quality investment, and in turn the ability of customers to experience low and stable energy prices.

To ensure the outcome of regulatory determinations is reasonable for customers and investors and promote regulatory predictability, the AER should adapt its methodologies over time, where previous methodologies are no longer appropriate. To investors, regulatory certainty and predictability means reasonable and consistent outcomes. It requires that the regulator proactively changes its approach where there is clear evidence that it is no longer delivering reasonable outcomes.

To its credit, the AER demonstrated that principle in 2007 when it adopted its existing approach to estimating expected inflation due to concerns with the liquidity of the inflation-linked bond market at a time when significant Commonwealth debt was being retired and no new debt was being issued. This meant that the bond breakeven approach applied at the time was no longer suitable (we note that this market is far more liquid today). The mid-point of the RBA band was the only credible alternative proxy for a long-term inflation estimate (noting it is not really an estimate as such).

In essence, the opposite is true today, the inflation-linked bond markets are robust and liquid, whereas, the RBA, economic forecasters and the markets all concede inflation will struggle to reach the lower bound of the RBA's target inflation band for an extended period of time, let alone come close to the mid-point that underpins the current methodology. This means the current methodology will constantly deliver an upward biased estimate.

Therefore, given prevailing market conditions, the liquid debt markets and the irrelevance of the RBA range in the medium term, the AER should change its approach to setting expected inflation by focusing on market data (inflation swaps and/or bond breakeven inflation). We also suggest a reform to the framework to target debt compensation in nominal terms. This would reduce risk for both customers and networks.

Urgent Need for Change

AusNet Services is extremely concerned that the AER's recent decisions for Ergon, Energex and SA Power Networks embed negative cash profits for the 5 year regulatory period. This is partly due to a 10 year inflation forecast set at 2.27%, well above market and leading economic forecaster estimates and, therefore, implausibly high in current economic conditions.

Indeed, AusNet Services has raised concerns about the current approach to setting expected inflation since 2014, when it proposed a move to breakeven inflation at a rate of 2.19% to set expected inflation in its 2016-20 distribution determination. Instead, the AER applied its current methodology and granted 2.32%. In the 2016-19 regulatory years actual inflation applied to roll forward the RAB has averaged 1.64%%. This means there has been a material gap between the efficient rate of return allowed in its 2016-20 determination and that which has been delivered.

It is urgent that the AER amends its inflation expectation methodology, to avoid locking in a further round of decisions that deliver negative profits in the Victorian distribution determinations, which will be made on 30 April 2021. Doing so would not compromise large price cuts for AusNet Services' customers because we have made a commitment to honour the prices agreed as part of our Customer Forum negotiation.

Extreme Impact of Current Conditions not seen in Current Data

While there has been a gap between expected and actual inflation for many years, this gap has sharply widened since the 2017 Inflation Review. To understand the severe impact of both current regulatory settings and market conditions on networks (locking in negative cash profits), the AER cannot rely on its backward looking profitability reporting data, dividend guidance or current credit ratings. When assessing whether the balance between cashflows and RAB growth delivered by the regime is appropriate, the AER needs to look at forward looking cash flow analysis, beyond the checks included in the PTRM, and financeability metrics.

This analysis would show that for Ergon, Energex and SA Power Networks, equity investors will receive a negative cash return, subsidising both debt holders and prices for current customers. If the inflation forecast was accurate, investors could expect to recoup this shortfall in their required return via asset growth – capitalised into the RAB as it grows by outturn inflation (which would be expected to match an unbiased estimate over the long run). However, market forecasts and RBA statements reveal the expert consensus is that outturn inflation will not be this high (1%[1] vs the AER's 2.27%).

Therefore, continuing with the current approach would have the following impacts:

- Subsidise current customers at the expense of investors and future customers;
- Would put cash flows and credit metrics under severe pressure, jeopardising the ability of networks to attract high quality investment. This will increase prices for customers over the long term; and
- It would not be consistent with the Revenue and Pricing Principles, as insufficient funds will be provided to meet building block expenses deemed efficient by the AER over the 5 year period.

[1] RBA, 10 year breakeven inflation, June 2020

The AER raises two issues in its review; whether its approach to setting expected inflation should change; and whether the regulatory regime should change. These are addressed in turn below.

Approach to Setting Expected Inflation

There is a material and growing gap between inflation expectations indicated by market data and the RBA's inflation target band, which anchors the AER's expected inflation methodology in eight out of the ten years. This has brought into sharp focus the fact that the approach cannot depart materially from the predetermined policy target (2.5%), regardless of expert and market expectations of inflation. Even implementing a glide path in this calculation will not be enough to resolve this mismatch. Any glidepath will continue to be heavily influenced by the midpoint of the RBA's target band.

Indeed, it is clear that the RBA itself does not 'expect' inflation to rise to within the target band (i.e. >2%), let alone to 2.5%, for an extended period of time. This is apparent by recent commentary:

> *..the Board also agreed that we would not increase the cash rate from its current level until progress was made towards full employment and that we were confident **that inflation will be sustainably within the 2–3 per cent range**. This means that we are likely to be at this level of interest rates **for an extended period**[2].*

Surveys of expected inflation are also not a robust measure. They are not transparent and less relevant than data from financial markets where participants have real money at stake.

Instead, market data should form the basis of inflation estimates – using either inflation swaps, or the bond breakeven approach. Market data is the most relevant and credible of alternative data sources at this time. It is also a direct measure of investor expectations. While there may be some biases embedded within these estimates, these are either small, irrelevant given the use of the estimate within the regulatory regimes or can be adjusted away.

What the industry is proposing is not controversial, radical or difficult to implement. Indeed, the use of market data to set expected inflation is a well-established regulatory practice internationally and was the past practice by the AER. For example:

- Ofgem use a bond breakeven approach;
- ERA use a bond breakeven approach; and
- The AER itself used a bond breakeven approach prior to 2008.

Should a Real, Hybrid or Nominal Return be Targeted?

To reduce volatility in revenues and prices, we consider a hybrid framework should be adopted. Networks issue debt in nominal terms. This is a long standing and efficient practice in Australian financial markets. Given this, providing nominal compensation for efficient nominal interest costs will reduce the mismatch between customer prices and the efficient costs of network businesses.

Importantly for customers, under a hybrid framework, any unanticipated increases in inflation will not be applied to roll forward 60% of the RAB, which will be welcome relief at a time when other

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[2] Philip Lowe, Governor RBA, *Responding to the Economic and Financial Impact of COVID-19*, 19 March 2020

cost of living pressures are increasing. Rather, the network's compensation will continue to match the efficient nominal debt costs at the time of issuance, which in these circumstances will include a lower inflation component than experience in the market.

The implementation of a hybrid framework does not need to wait until the 2022 Rate of Return Instrument. As long as the AER adopts an unbiased expectation of market inflation, the risk of outturn inflation deviating from this over a 5 year period is relatively low and is not expected to make an observable difference to the AER's long run estimates of equity parameters.

A hybrid framework is straightforward to implement through the existing regulatory models. It requires the same inflation figure to be input for the debt component of the RAB (i.e. 60%) into the RFM, the PTRM and annual pricing models.

Impact of Proposal on Customer Prices

Moving to a hybrid framework will not impact customer prices either immediately or over the long term. The revenue allowances set in the first determination which adopts a hybrid will be exactly the same, so there will be no price impact on customers. Under a hybrid approach, the RAB will be rolled forward during this period based on the AER's expectation of inflation, rather than actual inflation. Prices in the next regulatory period will only differ under a real vs hybrid regime if there is deviation between expected and actual inflation. If expected inflation is set using an unbiased forecast, deviations between expected and actual inflation will be symmetrical over time. Therefore, there is no long run price impact from moving to a hybrid regime.

The ENA's submission includes analysis showing that a hybrid regime does not alter long run price outcomes.

Need for a Thorough and Collaborative Process

Due to the significant future cash flow and financeability implications of the regulatory inflation approach, this review is critical to the sustainability of network sector's finances, credit metrics and ability to fund investment. Given the importance of this review and the fact that the impacts of the current approach are not currently visible from the data outlined above, we encourage the AER to thoroughly investigate the financeability impacts that will arise over the next 5 – 10 years if is persists with its current approach, before making a decision.

In addition, while expert reports being available early in the process are welcome, we were surprised that all three expert reports support the current approach while having not addressed the future cashflow impacts of the status quo approach, the widening gap between the RBA mid-point and market expectations and the customer impacts of this over the long term. In fact, when future cashflows are considered the expert reports, they are far more reticent to support the status quo, with Sapere observing '… a projected negative cash return on equity might indicate an underlying inconsistency in one or more inputs into its estimate of WACC and expected inflation'[3].

The Deloitte Access Economics report[4] is particularly concerning. DAE concludes that '.. the AER approach is still fit for purpose at present…'. However, DAE's own inflation expectations over the next 10 years are that inflation will be low, or 'as dead as a door nail'[5].

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[3] Sapare, Target Return and Inflation, 30 June 2020
[4] Deloitte Access Economics, Review of the regulatory treatment of inflation, 30 June 2020
[5] Deloitte, Business Outlook: Fast crisis, slow recovery, July 2020

AusNet Services' believes it would be illuminating if DAE publishes details on the geometric mean of its own inflation forecasts for the next 10 years that it supplies to its commercial and government clients. This would allow stakeholders to compare that number with the outcomes of the current methodology that the DAE upholds and fully assess whether the DAE conclusions are credible.

AusNet Services supports ENA's submission. Please contact Charlotte Eddy, Manager Economic Regulation on [redacted] with any questions about this submission.

Sincerely,

[redacted]

Tom Hallam
General Manager Regulation
AusNet Services