Locked Bag 14051
Melbourne City Mail Centre
Victoria 8001 Australia
T: 1300 360 795
www.ausnetservices.com.au

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

via email: AERInquiry@aer.gov.au; kenny.yap@aer.gov.au

Dear Warwick,

Re: Proposed amendments to the Electricity Distribution roll forward model (RFM)

AusNet Services welcomes the opportunity to provide a response to the Australian Energy Regulator's (AER) proposed amendments to the Electricity Distribution roll forward model (RFM).
AusNet Services has reviewed the AER's proposed amendments and observes that the amendments are largely consistent with those made in the TNSPs' RFM (version 3) published in October 2015. This response reflects views provided in our 2016-20 EDPR Revised Proposal, relating to opening RAB indexation. AusNet Services has addressed forecast inflation more broadly in its 2018-22 TRR Revised Proposal and provides a brief discussion of the key considerations in this response.

AusNet Services understands that the AER will apply its final amended RFM in subsequent regulatory control periods (i.e., from 2020 in AusNet Services' case), and not retrospectively apply its amended RFM to the 2016-20 control period for which a determination has already been made on the 2016 opening RAB value.

AusNet Services provides its detailed response to the AER's request for consultation in the Attachment.

AusNet Services would be pleased to discuss the attached submission in further detail with you at your convenience. Please contact Steven Martin on 03 9695 6109 or steve.martin@ausnetservices.com.au if you have any questions in relation to this submission.

Sincerely,

Anh Mai
Manager Economic Regulation
AusNet Services

Attachment: Detailed Comments on Proposed Changes to the Distribution Roll Forward Model

Indexation of the Opening RAB

AusNet Services observes that the proposed amended RFM maintains the same approach to inflation as the current model (version 1) by using the partially-lagged approach.

For reasons outlined in our 2016-20 EDPR Revised Proposal AusNet Services does not accept this approach in principle without any due consideration of compensation for DNSPs that have previously rolled forward the RAB under the all-lagged approach. We explain the need for such compensation arising from a shift to the partially-lagged approach together with our reasons for continuing with the all-lagged approach.

In response to an earlier AER request for consultation on its proposed amended Transmission RFM (Version 3)[1], AusNet Services' stated at the time[2] that it supported a change in the approach to indexation by applying a lagged CPI across all elements of the RAB within the RFM. That is, a lagged CPI should apply to the calculation of 'Opening inflation', 'Nominal (actual / forecast) straight-line depreciation' and 'Nominal net capex'.

We also stated at the time that this approach promotes consistency in the application of inflation within the model and removes a layer of unnecessary complexity. Additionally, the use of a lagged CPI rather than actual (non-lagged) CPI is also consistent with the methodology used in the calculation of annual MAR values.[3]

In its final decision on the Transmission RFM the AER rejected this approach and maintained its partially-lagged approach. The AER stated that [4]

> *"We agree that the consistent treatment of inflation indexation within the RFM is desirable. Above this, we also seek consistent treatment of inflation across the RFM, PTRM and the annual revenue adjustment process where revenue outcomes (and end user prices) are determined. It is not possible to use a single 'correct' inflation outcome across all of these regulatory elements… (emphasis added). We are satisfied that the approach in the final RFM implements the appropriate treatment of inflation across regulatory elements, even though this means different inflation treatment for different RFM components."*

In its final decision the AER also cited that [5]

> "*Indexing the opening RAB by actual CPI will ensure that the real value of the RAB is preserved, which aligns with the underlying premise for the PTRM."*

AusNet Services submitted in its 2016-20 EDPR Revised Proposal that this statement is only true if actual CPI is applied continuously (over time).[6]

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1 AER Explanatory statement - Proposed amendment to electricity transmission RFM - July 2015
2 AusNet (T) Response to AER consultation on RFM, 17 August 2015, p.2
3 Ibid.
4 AER Explanatory statement - Proposed amendment to electricity transmission RFM - July 2015, pp.11-12
5 AER Explanatory statement - Proposed amendment to electricity transmission RFM - July 2015, p.12
6 AusNet Services, Revised regulatory proposal, 6 January 2016, p.8-8

Applying an unbroken inflation series allows for maintenance of the real value of the RAB, as required under the NER.[7] The AER accepted AusNet Services' Revised Proposed approach stating that this consistency is desirable.[8] The AER also had regard to the indexation approach used in previous Victorian distribution determinations, where the Essential Services Commission (ESC) applied the all-lagged approach prior to 2010.[9]

As presented in our EDPR revised proposal, the use of an all-lagged approach meets the requirements of the NER to maintain the RAB value, and it is:

- Internally consistent within the RFM (i.e. the same CPI is applied to all model components);
- Consistent with the method of indexation used in the price control mechanism[10];
- Consistent with the inflation series applied in previous ESC models that were used by the AER in the 2011-15 Distribution Determination to establish the 2011 Opening RAB[11]; and
- Removes the need for a forecast of final year inflation.

AusNet Services reiterates that it is critical for the RAB to be rolled forward in a manner that reflects actual change in prices over time and ensures that no windfall gains or losses can occur from periodic shifts being made to the chosen inflation series.

AusNet Services' preference is to maintain the all-lagged approach for reasons outlined above. The AER's consultation paper makes the same conclusion for Victorian DNSPs that have historically used the all-lagged approach, stating that [12]

> "*On balance, our current assessment is that the Victorian distributors should be allowed to stay on the all-lagged approach, judging that the benefit of consistency with past treatment outweighs the detriment of potential greater revenue variation.*"

Given this a separate RFM model for Victorian DNSPs adopting the all-lagged inflation approach should be promulgated by the AER.

Any proposed departure from this approach must include adequate compensation at the next regulatory reset (i.e., in the form of an opening RAB adjustment (or similar)) to ensure that DNSPs are kept whole.

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7 NER, Clause S6.2.3(c)(4).

8 AER, Final decision AusNet distribution determination – Attachment 2 – Regulatory asset base – May 2016, p.2-12

9 AER, Final decision AusNet distribution determination – Attachment 2 – Regulatory asset base – May 2016, p.2-11

10 NER, Clause 6.5.1(e)(3)

11 AER, SP AusNet RFM Final Decision, October 2010 (Amended 18 July 2013)

12 AER, Explanatory Statement – Proposed Amendment – Electricity distribution network service providers Roll Forward Model (version 2), 31 August 2016, p.18

Forecast Inflation

Forecast and actual inflation affect revenues through both the PTRM and the RFM. While this consultation paper focuses on proposed amendments to the RFM, the consultation paper contains important commentary on the need for consistency in the two inflation forecasts that feed into the PTRM: [13]

> *"A nominal WACC, not a real WACC, is the input to the PTRM at the start of each AER final decision. The real WACC (which drives PTRM outcomes) is derived from the nominal WACC by deducting the expected inflation rate. Hence, an overestimate of inflation means the real WACC will be too low (and vice versa). However, the forecast inflation and the nominal WACC are jointly estimated on consistent terms. Directly using the real WACC in the model means we have assumed that this pair of inputs is correctly matched. For example, if forecast inflation is overestimated, but this overestimate of inflation is already included in the nominal rate of return, the real WACC will still be correct. Hence, the construction of the model means we isolate changes in revenue outcomes that reflect the difference between forecast and actual inflation, not errors in the forecast inflation embedded in the WACC." (footnotes removed)*

The AER explains in a footnote that consistency between the forecast inflation and the nominal WACC is achieved as 'forecast inflation in the PTRM is a constant inflation rate with a 10 year horizon'[14].

AusNet Services strongly agrees with the AER that consistency is required between:

- the forecast inflation embedded in the nominal WACC; and
- the separate forecast inflation input into the PTRM.

If consistency is not achieved, the real WACC will either be too high or too low. This will impact allowed revenues. It is important to highlight that this revenue impact arises due to the mismatch between the two sources of forecast inflation input, rather than due to the accuracy of either one of the inflation forecasts.

Over the past two years, the AER's inflation forecasting methodology (which draws on the RBA's inflation target band) has not produced results that are commensurate with forecast inflation embedded in the nominal WACC, being that which is expected by the market. As such, the two sources of forecast inflation that feed into the PTRM have differed significantly.
The impact of this difference on the real WACC is most starkly observed in the AER's 29 September 2016 Draft Decisions for TasNetworks and Powerlink. These decisions embed a negative real risk free rate of around -0.5%[15].

However, investors in Australian financial markets can currently achieve a positive real risk free rate of return of around 0.4%, through investing in index-linked Commonwealth Government

[13] AER, Explanatory Statement – Proposed Amendment – Electricity distribution network service providers Roll Forward Model (version 2), 31 August 2016, p.26

[14] AER, Explanatory Statement – Proposed Amendment – Electricity distribution network service providers Roll Forward Model (version 2), 31 August 2016, p.26, footnote 67.

[15] The real risk free rate is approximately equal to the nominal risk free rate (1.95%) less forecast inflation (2.45%).

Securities. Two assets with equivalent risk profiles must have identical yields[16]. Therefore, the negative real risk free rate applied in the Draft Decisions is inconsistent with market conditions and does not reflect reality. AusNet Services urges the AER to consider whether, given this evidence and the above quote from the Consultation Paper, the implied real WACC used in the PTRM can be considered to be correct.

AusNet Services has provided evidence that this is the case in its transmission Revised Revenue Proposal, which was submitted to the AER on 21 September 2016. It proposes that the two inflation forecasts should be consistent to avoid distorting allowed revenues.

Notwithstanding the fact that the AER is required to address this issue in AusNet Services' Transmission Final Decision for the 2017-22 regulatory period, AusNet Services would support the AER in undertaking a comprehensive review of the role of inflation within the regulatory context, including through the RFM and PTRM, and the relevant requirements under the National Electricity Rules.

[16] If this did not hold arbitrage opportunities would be possible and, in an efficient market, would be exploited until a single yield were achieved.