Ausgrid Submission

AER Inflation Review

6 November 2020

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Ausgrid

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Mr Warwick Anderson
General Manager, Networks Finance and Reporting
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Mr Anderson

Ausgrid welcomes the opportunity to provide this submission in response to the AER's draft inflation position (draft position). We appreciate the AER initiating the review in response to changing economic circumstances that have influenced how inflation is treated in the regulatory framework.

We support some aspects of the draft position, in particular moving to a five-year estimation period and a glide path for the estimate of inflation. We note that the end point of the glide path is the subject of discussion in some other submissions.

We are however disappointed with other aspects and we request clarification of how certain evidence was evaluated in order to reach the AER's proposed approach. For example, the current regulatory framework does not produce financeable outcomes in the current low inflation, low interest rate environment, and we request a more detailed explanation of how this outcome is consistent with the regulatory framework under which we operate.

Ausgrid supports the submission made by Energy Networks Australia (ENA) on behalf of energy networks.

If you would like to discuss our submission in more detail, please contact Fiona McAnally on [redacted] or [redacted]

Yours sincerely

[redacted]

Rob Amphlett Lewis
Chief Customer Officer

Rate of return framework

The draft position taken by the AER was to maintain the current real rate of return framework because neither a nominal or hybrid framework is preferable based on the evidence before the AER[1]. We acknowledge the AER's position, including that a change of this nature would require a rule change. However, it is not clear how some of the evidence that was presented was evaluated by the AER in making its decision. The sections below outline specific issues which we believe require further consideration by the AER.

Achievement of the NEO/NGO

In the draft position several considerations were taken into account before deciding whether another approach would promote the National Electricity Objective or National Gas Objective (NEO/NGO) to the greatest degree[2]. It is unclear whether these considerations have been interpreted by the AER to be assessment criteria for whether an alternative approach promotes the NEO/NGO better, or if they have been used to reject an alternative approach prior to making an assessment against the NEO/NGO.

To assist with stakeholders' understanding it would be helpful if the AER could provide further information about the following observations that were made regarding the current real framework in comparison to the hybrid as outlined in Table 1:

[1] AER, Draft position | Regulatory treatment of inflation, October 2020, p 7.
[2] AER, Draft position | Regulatory treatment of inflation, October 2020, p 75.

Table 1

#	Issue	Ausgrid comments	Request for final position
1	Transparency of approach to inflation and its compensation is highest under the current framework[3]	Under the hybrid framework an inflation estimation must still be made, meaning it is therefore possible to track the implicit and explicit compensation and how it compares to actual inflation. This indicates that there would be no loss of transparency in relation to actual inflation and compensation.	We would like to understand how the view was formed that there would be a loss of transparency
2	Change of risk from the party who is best placed to manage that risk, noting that submissions had not been comprehensive about risk changes[4]	As noted in some submissions, the risk of actual inflation being different to estimated inflation from period to period is borne by both equity holders and customers (see Figure 1). The hybrid would mean that customers only pay the efficient cost of debt, reducing the estimation risk of inflation. See also #3 regarding ability to manage the risk.	Further explain how compensating for efficient nominal debt costs through regulated asset base (RAB) indexation is a transfer of risk to customers.
3	In response to submissions that it is not feasible to manage the risk that actual inflation will be different the AER estimate, it was noted that some toll road entities hedge some of their debt costs to better match their real revenue stream[5]	The market in Australia to swap nominal to real is extremely limited, very expensive (basis point margins up to 20 times higher than standard swaps) and with very small transaction sizes, would be ineffective for the scale of transactions required to hedge the debt costs of the energy networks in the NEM.	Provide more information about the volume, timing, rating and sector of these hedges.
4	It was noted that risk could also be reduced by reducing gearing[6]	Ausgrid analysis showed that its regulatory determination did not provide an FFO/Debt consistent with either the benchmark credit rating of BBB+ or a lower rating of BBB, based on the decision PTRMs with benchmark gearing of 60%[7].	Provide more information about how the AER assessed the impact to credit metrics at the benchmark credit rating.

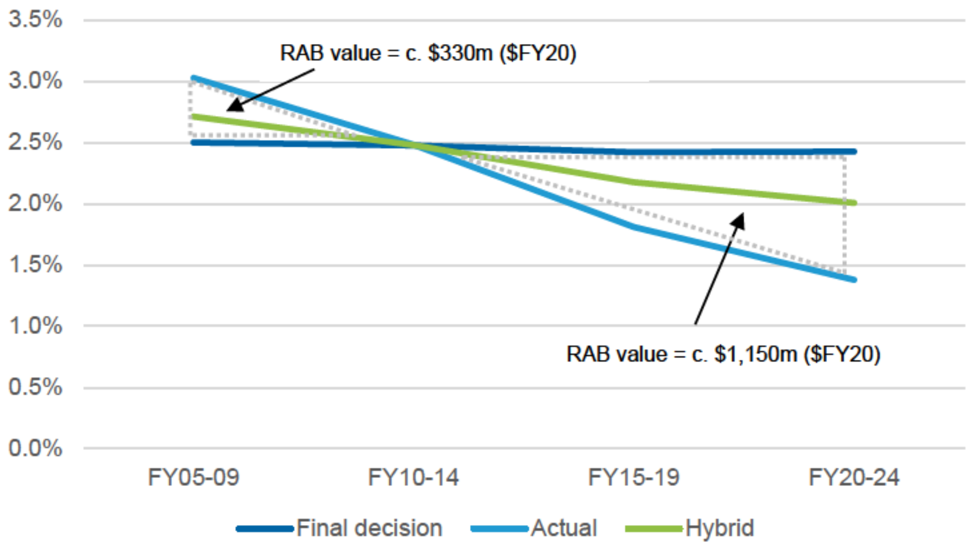
[3] AER, Draft position | Regulatory treatment of inflation, October 2020, p 76.
[4] AER, Draft position | Regulatory treatment of inflation, October 2020, pp 77-78.
[5] AER, Draft position | Regulatory treatment of inflation, October 2020, p 80.
[6] AER, Draft position | Regulatory treatment of inflation, October 2020, p 80.
[7] Ausgrid, Confidential submission to discussion paper, inflation review 2020, July 2020 (unpublished).

#	Issue	Ausgrid comments	Request for final position
5	More implementation details required[8]	The hybrid would involve calculating a weighted average inflation figure using two weights (equity and debt proportions prevailing at the time) and actual and estimated inflation, for each year of a regulatory period. These calculated numbers would then be inserted, as per the current process, into the relevant cells in the RFM. This would involve updating the RFM guideline. There would be no change to opex forecasting needed.	Identify whether there are any remaining implementation concerns.
6	Lack of precedent by other monopoly regulators[9]	We are unclear about how the lack of regulatory precedent is relevant in assessing whether a change achieves the NEO/NGO to a greater degree than the status quo. The possibility of unintended consequences always exists: it is something customers and networks businesses are experiencing now under the current framework and which has prompted this review.	Further information about how regulatory precedent affects assessment of the NEO/NGO criteria.
7	Customer outcomes	The draft position didn't appear to engage with the analysis provided by ENA which demonstrated that revenues (and thus prices) under the proposed hybrid and an unbiased inflation expectation were not materially different over the long term compared to the current framework.	Explanation of AER views of the analysis provided in the ENA submission.
8	A hybrid would intervene in the capital structure decision[10]	It is not clear how a hybrid implemented in the way suggested by ENA would change decisions on capital structure.	Elaboration on how a hybrid would change decisions on capital structure.

[8] AER, Draft position | Regulatory treatment of inflation, October 2020, p 81.
[9] AER, Draft position | Regulatory treatment of inflation, October 2020, p 79.
[10] Sapere, Target return and inflation - Input to the AER Inflation Review 2020, 30 June 2020, p. 30 quoted in AER, Draft position | Regulatory treatment of inflation, October 2020, p 77.

As noted in issue #2 in Table 1, a hybrid does not transfer risk from equity holders to customers. Figure 1 shows the geometric average of RAB indexation for Ausgrid (previously EnergyAustralia) in each regulatory period since 2005 against the estimate. It also shows what the indexation would have been under the hybrid proposed by industry.

Figure 1: RAB indexation since 2005



The hybrid would smooth out gains and losses from period to period rather than transfer risk from one party to another. It would also assist with the financeability issue described below.

Financeability

The current framework is causing extended periods of negative net profit after tax (NPAT) and negative cash equity returns, an outcome which was acknowledged by the AER in its June 2020 final decisions for SAPN, Energex and Endeavour. These outcomes do not accord with real-world requirements to maintain credit metrics and debt covenants[11].

The draft position responds that part of the equity return is provided through RAB indexation which increases capital value, a point which was acknowledged by stakeholders who raised the issue[12]. As also noted in submissions, future RAB indexation is not taken into account in calculating profit and loss, credit metric or debt covenants. This problem has been

[11] See for example: Ausgrid, Submission to discussion paper, inflation review 2020, July 2020, p 5 and ENA, A hybrid approach that has regard to market data, Response to AER review of regulatory treatment of inflation, 29 July 2020.
[12] Ausgrid, Submission to discussion paper, inflation review 2020, July 2020, p 5 and ENA, A hybrid approach that has regard to market data, Response to AER review of regulatory treatment of inflation, 29 July 2020.

crystallised for Transgrid and Electranet who have been forced to submit rule change requests to change inflation treatment to be able to fund significant new investments[13].

The principle of cash flows achieving NPV=0 over the life of an asset is commonly used when assessing the current framework or potential changes to it. Ausgrid suggests that this principle should be tempered with some recognition of the interaction of cash flows delivered by this principle and the real-world constraints of running and financing a business. As a simple example, consider the two sets of cash flows in Table 1. Both sets of cash flows yield zero NPV using a 5% discount rate.

Table 1: Two examples of NPV=0

	NPV	Yr0	Yr1	Yr2	Yr3	Yr4	Yr5	Yr6	Yr7	Yr8	Yr9	Yr10
A	$0	-70	5	6	7	8	9	10	11	12	13	14
B	$0	-70	9	9	9	9	9	9	9	9	9	9

In theory, an investor should be indifferent between the two cash flows. However, NPV=0 is not the only decision faced by investors and shareholders. For example, if the revenue required to maintain credit metrics and debt covenants is $8, a business would be in serious financial difficulty under cash flow A for years 1 to 3. This demonstrates that the theoretical NPV=0 principle requires an appreciation of financeability factors, particularly in a world with low inflation and low interest rates.

It would be helpful if the AER could respond specifically to the problem raised by network businesses that a framework delivering extended periods of negative NPAT and negative equity returns does not fit with how networks operate and are funded in the actual economy.

Inflation estimation

Ausgrid welcomes the changes to inflation estimation in the draft decision. Both the glide path and five-year estimation period are improvements that will benefit stakeholders over the long term. Suggestions regarding the glide path target are raised in other submissions and we encourage the AER to consider those ideas.

However, we remain of the view that inflation swaps should have a role in inflation estimation. The RBA's second year forecast appears to be biased upwards particularly when compared to inflation swaps. The result of second year estimates being higher than other forecasts is that the starting point for the glide path is too high, giving an overall inflation estimate that is higher than true expectations. The ENA submission provides more detail on this matter.

On the question of defining the form of inflation forecast from the RBA's Statement on Monetary Policy that should be used, Ausgrid is in favour of maintaining flexibility to use

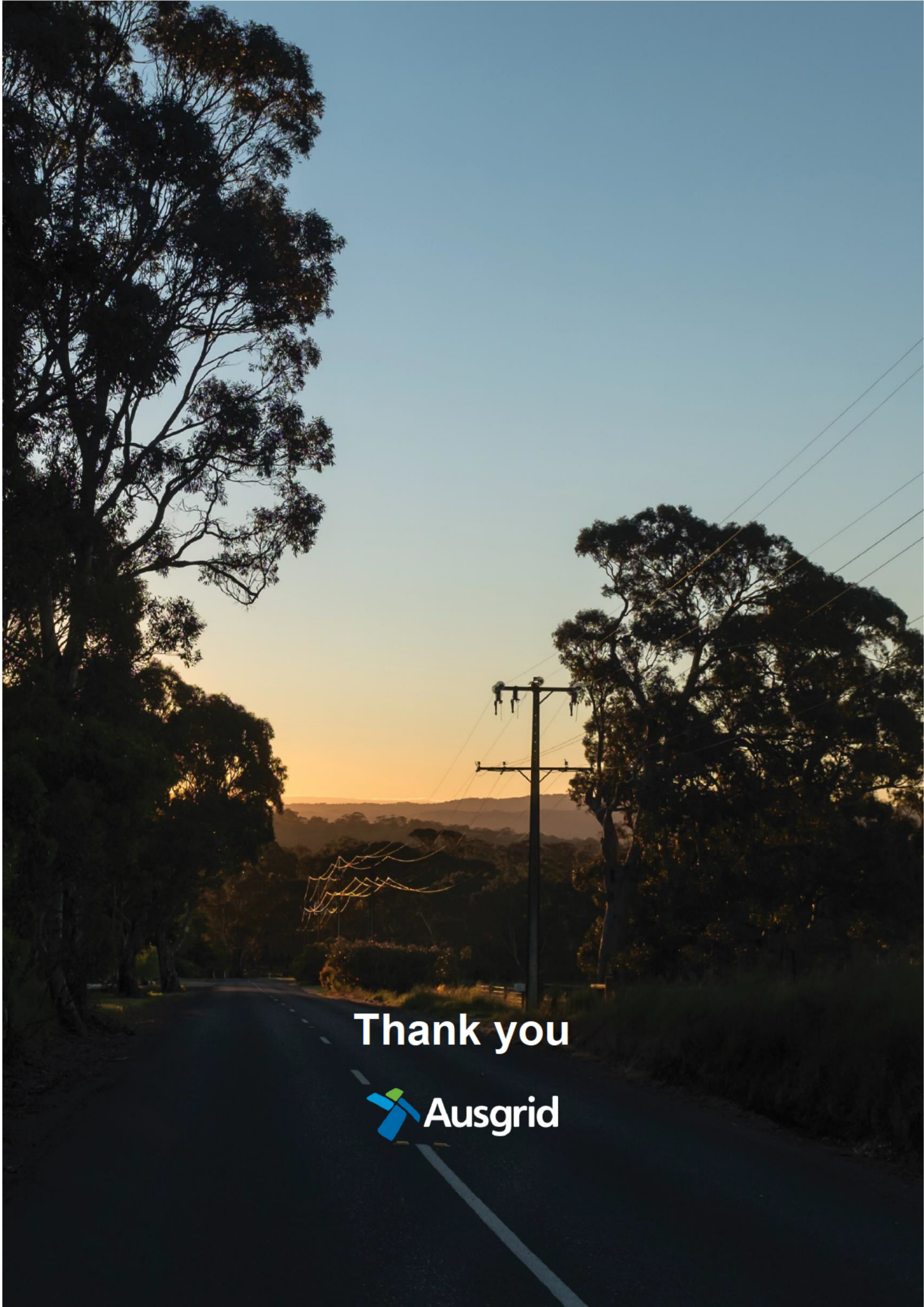
[13] https://www.aemc.gov.au/rule-changes/participant-derogation-financeability-isp-projects-transgrid and https://www.aemc.gov.au/rule-changes/participant-derogation-financeability-isp-projects-electranet

discretion based on the circumstances at the time. The flexibility to use trimmed mean inflation where appropriate is important in extreme circumstances such as those experienced in 2020.

Transition to five-year average

It was suggested in the draft position that it may be appropriate to implement a transition to the five-year estimation term[14]. Ausgrid does not support a transition mainly because the AER has assessed that the five-year term is “likely to achieve the NEO/NGO to the greatest degree”[15]. To delay implementing an estimation method considered superior to the current method seems counter to achieving the NEO/NGO. Further detail on this matter is contained in the ENA submission.

[14] AER, Draft position | Regulatory treatment of inflation, October 2020, p 69.
[15] AER, Draft position | Regulatory treatment of inflation, October 2020, p 46.



Thank you

Ausgrid