



6 November 2020

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

Dear Warwick

Re: Regulatory treatment of inflation

CitiPower, Powercor and United Energy welcome the opportunity to comment on the AER's October 2020 draft position on the regulatory treatment of inflation (Draft Position).

In summary, this submission concludes that:

1. The Draft Position is correct to use a five-year term for the Post Tax Revenue Model (PTRM) inflation forecast.
2. The Draft Position takes a significant step toward bringing regulatory inflation estimates towards the best estimate of future inflation. However, it is likely to be over-estimating inflation expectations in the current low inflation environment.
3. There is no reason to defer or adopt a transition to a better inflation estimate.

1. Inflation term

For the purposes of the discussion in this section, we assume that the length of a regulatory period is five years.

Purpose of expected inflation in the PTRM is to estimate actual inflation that will be applied in the Roll Forward Model (RFM)

Chapter 6 of the NER only mentions inflation three times:

- the contents of the PTRM must include a method that the AER determines is likely to result in the best estimate of expected inflation;
- the building blocks in the PTRM must comprise a negative revenue adjustment for an amount necessary to maintain the real value of the regulatory asset base as at the beginning of the later year by adjusting that value for inflation; and
- the RFM must adjust the RAB for actual inflation.

The published PTRM and RFM are consistent with these NER requirements:

- the PTRM provide a negative revenue adjustment for expected inflation of the RAB; and
- the RFM adjusts the RAB annually for actual inflation.

All else being equal, investors would only expect to earn the regulated nominal rate of return if inflation used in PTRM to calculate the negative revenue adjustment was an expectation of actual inflation that will be used to adjust the RAB in the RFM for the five years of the regulatory period. This is analogous to the capital expenditure forecast in the PTRM which reflects an expectation of the actual capital expenditure that will be

added in the RFM for the five years of the regulatory period. It does not make sense to input into the PTRM the average forecast capital expenditure for the next ten years when the PTRM is only forecasting capital expenditure for the next five years.

Inflation forecast has nothing to do inflation expectations embedded in the nominal rate of return

Indexing the RAB by actual inflation supports consumer charges moving in line with actual inflation.

The negative revenue adjustment is a consequence of the RAB being indexed by inflation. Providing networks with a nominal return and indexing the RAB by inflation would result in networks earning a nominal cash return and a capitalised inflation return that would be over-compensation. Therefore, the NER requires that a forecast of capitalised inflation be deducted from the cash revenue allowance.

There is no link to the rate of return. If the NER had intended that a real cash return be provided in the revenue allowance, then it would have required that a real return be estimated and input into the PTRM. The PTRM does not apply a real return nor does it deduct forecast RAB inflation from nominal return on assets. Rather, the PTRM deducts forecast RAB inflation from depreciation that is applied in the RFM because the purpose of expected inflation in the PTRM is to estimate actual inflation that will be applied in the RFM over the regulatory period.

Therefore, the purpose of expected inflation in the PTRM is not to estimate inflation expectations embedded in the nominal rate of return (which has a ten-year term), but rather to estimate actual inflation that will be applied in RFM over the next five-year regulatory period.

2. Best estimate

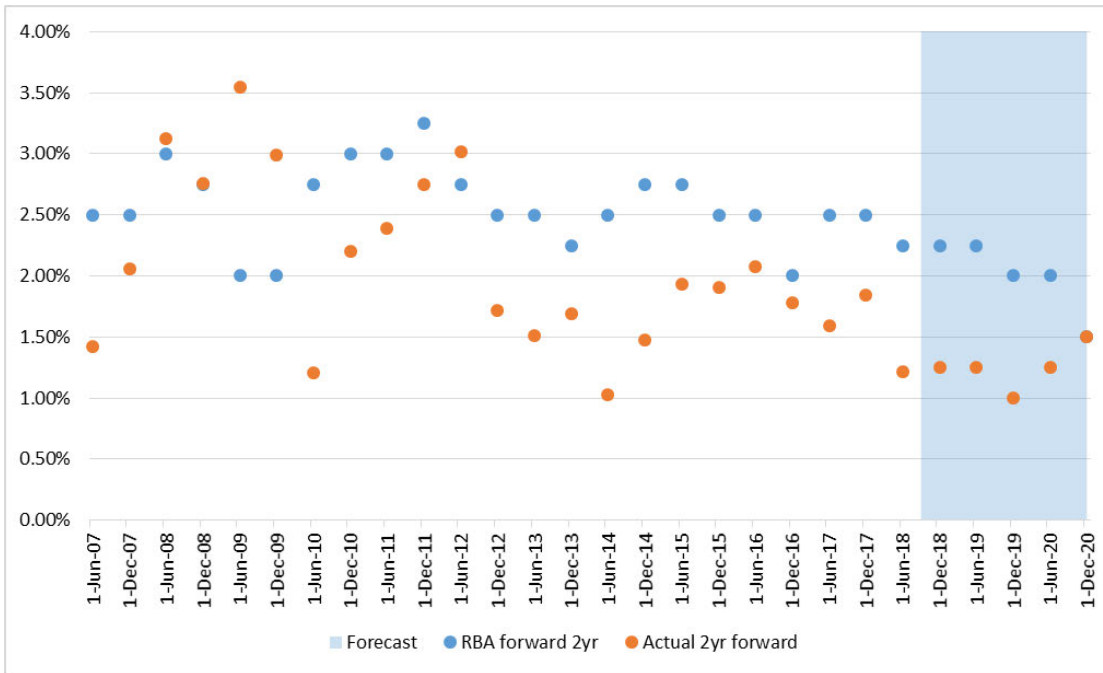
Glide-path provides a better estimate

We agree with the Draft Position that applying a glide-path is likely to result in a better estimate of expected inflation because it may take a number of years for inflation to return to the mid-point of the RBA's target band following a disturbance. The glide-path approach is symmetric as it can accommodate disturbances that result in sustained periods of either high or low inflation.

Glide-path method currently likely to overstate inflation

Figure 1 below shows that, over the last decade, the RBA forecast of second-year inflation has been persistently and materially higher than actual inflation outcomes.

Figure 1: RBA Year 2 forecast vs. actual inflation for that year



Source: ENA presentation, AER Inflation Review Public Forum, 21 October 2020

The 5-year glide-path approach places 40 per cent weight on the Reserve Bank of Australia (RBA) forecast for the second year. Therefore, in the current low inflation environment the Draft Position approach is likely to over-estimate inflation.

Whilst the RBA second year forecast may important to consider, we believe that the best estimate would not be reached by placing 100 per cent weight on this forecast without consideration of other forecasts, such as from inflation swaps.

3. Deferral / Transition

Deferral or transition will result in an expected windfall loss for networks

In the prevailing low inflation conditions, the continued use of a 10-year estimate without a glide path will result in an expectation of the under-compensation of service providers over the upcoming regulatory period. It will deliver higher inflation estimates than those delivered by a 5-year term with a glide path, which the AER has concluded is likely to result in the best estimate of expected inflation. Consequently, it will result in service providers expecting to receive a lower allowance for RAB indexation over the upcoming regulatory period in the RFM than the amount of expected inflation deducted from the revenue allowance in the PTRM.

Table 5 in the Draft Position estimates that for the upcoming Victorian distribution decisions, the current method will estimate inflation of 2.30% but the best estimate (5-year term with glide path) will estimate inflation of 1.95%. The Draft Position goes on to estimate that current method delivers \$300m less revenue to the Victorian distributors compared to applying the best estimate of inflation.

Adopting a transition or deferral means that Victorian distributors could face an estimated \$300m windfall loss. Expected windfall losses or gains are only avoided if the AER immediately adopts the best estimate. Any transition or deferral will result in an expected windfall loss or gain.

Expected windfall loss is material

The Draft Position goes on to state that the \$300m less revenue is a 0.36% reduction in the real rate of return. Holding all else constant, all of this shortfall would be borne by equity investors since distributors have to meet their contractual obligations to debt investors. The 0.36% shortfall in the rate of return is a 0.90% shortfall in return on equity which is about a 20% reduction in nominal equity returns and about a 35% reduction in real equity returns.

This is further exacerbated because the regulated nominal return on equity for Victorian distributors is expected to fall from 7%-7.5% in the current regulatory period to less than 4.5% in the next regulatory period.

The current inflation estimation method results in an expectation of material under-compensation in the current market conditions. It would be reasonable to expect that under these circumstances distributors would come under pressure from their shareholders to spend less than efficient costs which are unlikely to be in the best long term interests of consumers.

AER has an obligation to apply a best estimate

The very first words of the Draft Position are:

“It is our role to **determine a method that is likely to result in the best estimate of expected inflation** (emphasis added).¹”

Having formed this view, and determined that the best estimate of expected inflation provides a materially better estimate to current method, the AER has a duty to amend the PTRM.

Draft Position approach is simple to implement

The Draft Position approach:

- involves no more than changing the weights applied to the same three pieces of evidence – the RBA 1-year and 2-year forecasts and the 2.5% mid-point of the RBA inflation target range
- makes no assumptions about any change in the way a benchmark efficient firm would be operated
- requires no change to any regulatory model other than inserting a different input value into the PTRM; and
- the inflation slate is wiped clean at the end of every regulatory period so there is no sense in which a 10-year estimate must or should be left to ‘run its course.’

No connection to the next rate of return review

We have already concluded that the purpose of expected inflation in the PTRM is to estimate actual inflation that will be applied in RFM over the next five-year regulatory period, and not to estimate inflation expectations embedded in the nominal rate of return. Therefore, there is no reason to defer implementation until after the next rate of return review.

¹ NER, cl. 6.4 2(b)(1), 6A.5.3(b)(1); NGR, r. 75B.

Transitions have not been adopted for recent regulatory changes

In December 2018 the AER reduced the equity risk premium from 4.20% to 3.66% through adjustments to the market risk premium and equity beta. The AER adopted the new equity premium with no transition.

In December 2018 the AER increased the value of imputation credits from 40% to 58.5%. The AER adopted the new value of imputation credits with no transition.

In December 2018 the AER changed its approach to the estimate of the regulatory tax allowance. The AER deemed that the new approach to be a better estimate than the previous approach. The AER adopted the new approach with no transition.

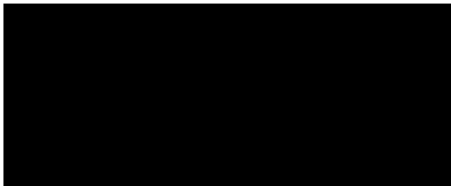
In all of the above three examples, the changes that were immediately adopted by the AER with no transition all acted to reduce network prices.

Current circumstance is different to the debt transition

Appendix A explains why the Australian Competition Tribunal decision in relation to a transition to the 10-year trailing average debt approach (*Application by ActewAGL Distribution [2017] ACompT 2*) is not relevant to an estimate of expected inflation.

Should you have any queries, please contact Mark de Villiers on [REDACTED] or [REDACTED].

Yours sincerely,



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General Manger Regulation
CitiPower, Powercor and United Energy

Appendix A: Application by ActewAGL Distribution [2017] ACompT 2

While the Australian Competition Tribunal concluded, in Application by ActewAGL Distribution [2017] ACompT 2 (Debt Transition Decision), that there was no error in the AER's application of a transition from an on-the-day approach to a historical trailing average approach for estimating the cost of debt, this decision is of no present relevance. The Tribunal considered markedly different NER provisions to those presently in issue in the Debt Transition Decision, and its decision was premised on its conclusions regarding those provisions and their interpretation. This is readily apparent from the Tribunal's reasoning in the Debt Transition Decision, which can be summarised as follows:

- the NER provided a discretion, without limitation, to choose between the on-the-day approach, the historical trailing average approach or some combination of the two (at [97] and [132]);
- the AER was therefore required by the NEL to consider which approach would contribute to the achievement of the ARORO to the greatest degree (at [98]);
- the ARORO is informed by the economic theory of investment (at [108], [121] and [163]);
- in this economic theory, the rate of return on an investment is an opportunity cost – it is the rate of return required ex ante by the investor given the risks of that investment, which is, in turn, the rate of return just sufficient to give the investment's stream of cash flows an NPV of zero (at [107] and [108]);
- this required rate of return is independent of the financing of the investment or, in the case of a firm's assets, of its capital structure (at [111]);
- the NER requires the overall rate of return to be determined such that it achieves the ARORO – that is, an overall rate of return that is 'commensurate' with the efficient financing costs of the benchmark efficiency entity for the service provider in question (at [114], [117] and [158]);
- estimation of the return on debt cannot individually achieve the ARORO; the NER requires the return on debt to be determined so as to 'contribute' to the achievement of the ARORO (at [114] and [117]);
- the term 'efficient financing costs' in the ARORO does not necessitate a search for efficient debt management practices but rather the ascertainment of whether the return on capital (overall) is commensurate with efficient financing costs (at [133] and [135]);
- the conventional view (which the Tribunal accepts) is that this involves a forward-looking cost of capital, which in turn, implies the use of prevailing, or current, rates in the market (at [158]);
- as the current market cost of debt is considerably below the average over the last 9 years, implementing the historical trailing average approach immediately would deliver the service provider a windfall gain and be inefficient, unless that provider had legacy debt (at [144]);
- both the on-the-day approach and the historical trailing average approach to estimating the return on debt incorporate past interest rates, rather than prevailing rates, as adherence to the prevailing rate principle cannot be achieved in practice – in the words of the Tribunal, 'no approach that does apply a true opportunity cost of capital is available' (at [164] and [188]);
- nonetheless, there is ample support for the fact that the on-the-day approach can contribute to the ARORO and the AER was correct to take the view that it could (at [184] and [186]);
- as the AER also considered the historical trailing average approach would, in due course, contribute to the ARORO, the AER was bound to consider alternatives including its transition (at [188] and [189]);
- '[b]oth the on-the-day approach and the transition are specifically provided for in the Rules and it is clear that the AEMC considered that both could contribute to the ARORO in certain circumstances' and

‘that it was a matter for the AER in each particular case’ which approach would contribute to the ARORO (at [189]).

In implementing the return on debt transition, the AER was choosing between approaches to estimation of the return on debt in circumstances where:

- no approach would deliver a true opportunity cost of capital, as adherence to the prevailing rate principle cannot be achieved in practice;
- the historical trailing average approach would deliver a rate of return materially above prevailing rates and thus that opportunity cost of capital; and
- the NER provisions relating to the estimation of expected inflation do not specifically provide for a transition to the approach that the AER considers likely to result in the best estimate of expected inflation.

No analogy with this can be drawn here.

The AER has determined that a 5 year inflation term is likely (and more likely than a 10 year inflation term) to result in the best estimate of inflation. The corollary is that any transition from a 10 year inflation term or prolonging of the use of such a term is necessarily less likely to deliver the best estimate of inflation and will result in significant under-compensation of service providers. In contrast to the rate of return provisions of the NER, the inflation related provisions make no provision for such a transition to or deferral of the implementation of the method likely to result in the best estimate of inflation, and provides the AER with no discretion to implement such a transition or deferral. The AER is required to implement the method it has determined likely to result in the best estimate of inflation – that is, a 5 year inflation term.