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Subject: Follow-up to AER Technical Inflation Workshop – Thursday 13 August - Proposal for Further Meeting – Framework and Threshold Model Issues
Date: Monday, 17 August 2020 2:47:27 PM
Attachments: image001.png
image002.png
image003.jpg
AER - Final Decision - Energex distribution determination 2020-25 - PTRM - Public - June 2020.xlsm

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Hi Eric, Warwick and Robyn

Follow-up to AER Technical Inflation Workshop – Thursday 13 August

The ENA Rate of Return Working group wanted to thank the AER for last Thursday's workshop, in particular Jonathan for his presentation of the different scenarios.

We also appreciate the AER engaging on a wide range of options and keeping an open mind at this stage of the review. We also found the last part of the session – the discussion with the members of the AER Consumer Reference Group – really insightful and we are keen to have the opportunity to engage further to ensure that both the ENA and the CRG fully understand the implications of each other's proposals.

As mentioned in the workshop, while the revenue and price impacts of the various options are an essential part of the assessment, it is difficult to see how the options can be properly assessed against the NEO/ NGO without also considering whether, and in what circumstances, prices reflect benchmark efficient network costs in each scenario. It is important to consider whether this is true in both in the long run and in the short run, and the implications of deviations for customers, networks and investors. A similar exercise was carried out in 2013 in assessing the impacts of moving to a trailing average cost of debt which started with a common understanding of all stakeholders of the problem to be addressed.

In recent decisions the prices are set lower than efficient costs – the 'return on capital' component of allowed revenues is insufficient to pay the benchmark efficient interest bill in every year. As contracted debt repayments must be made in nominal terms each year, negative cash returns will be delivered - of $268.5m for equity investors over the 5 year regulatory period in the example model attached - even if the *ex ante* inflation forecast turns out to be correct.

This is demonstrated in the attached slightly augmented version of the recent Energex PTRM, which we are happy to take the AER/ CRG through in detail. The impact is to lower current customer prices but at the cost of future customers. For networks, this raises material cashflow concerns which could impact credit ratings – as rating agencies assess short term cashflows in setting ratings, rather than whether NPV=0 is expected to be achieved over the life of the asset.

The reverse of the above scenario could equally apply in future, under different market conditions. Where outturn inflation applied to the debt allowance significantly exceeds the AER's initial expectation, under the current regime, customers would materially overpay for network's efficient costs.

Whether prices should reflect efficient debt costs in each regulatory year, or in expectation over the life of the asset, will inform whether a real or nominal return on debt should be targeted. It is also important to note that if a nominal return of debt were targeted, ENA's hybrid proposal would not impact prices in the first 5 years compared to the status quo. Longer term prices will only be impacted where expected inflation differs from outturn inflation.

Proposal for Further Meeting – Framework and Threshold Model Issues

We seek a follow-up meeting with the AER, CRG and ENA (potentially with a smaller number of attendees than the Thursday workshop). There would be enormous value in considering the issues referred to above (to ensure understanding of the issues under consideration and transparency) prior to the AER considering the various options ahead of the draft decision. We are also available to work with the AER on modelling the additional scenarios discussed in the workshop.

Such as session would enable the consideration of several framework issues

1. **Identifying the critical problems:** Noting that there has not yet been any consultation about the primary problems that have led to this review. The attached spreadsheet clearly identifies those problems. It is difficult for any engagement to be effective unless all stakeholders have a clear understanding of the problems that we are seeking to address. As mentioned, this is a slightly augmented version of the recent Energex PTRM The added calculations are all set out at the bottom of the **Analysis** tab. It demonstrates that:

   a) NPAT is materially negative in every year.

   b) The 'return on capital' component of allowed revenues is insufficient to even pay the benchmark efficient interest bill in every year.

   c) Current consumers contribute a negative amount to the return on equity (i.e., networks are paying consumers over the current regulatory period) at the expense of future consumers.

   d) For an investor who expects inflation to be below the AER's estimate, the total expected return to equity (nominal and real) is very low.

2. **Clarifying objectives and assessment criteria -** AER has noted that it has not yet considered what its objective should be. For example, whether its objective should be to deliver a real or nominal return on debt. This is a very important component (indeed the most fundamental component) of the review, so it is important for there to be consultation on that point. It may well be that there are some common views between networks and consumers on this point. If so, it would be very useful for the AER to be aware of that.

We look forward to talking soon and participating in the next steps in this important review.

Cheers

Garth

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