Jemena Gas Networks (NSW) Ltd

Revised 2020-25 Access Arrangement Proposal

Attachment 7.2

Response to the AER's draft decision - Inflation

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Abbreviations

AA	Access Arrangement
AER	Australian Energy Regulator
ENA	Energy Networks Australia
ERA	Economic Regulation Authority
PTRM	Post-Tax Revenue model
QTC	Queensland Treasury Corporation
RAB	Regulated Asset Base
RBA	Reserve Bank of Australia
RoR	Rate of Return
SAPN	SA Power Networks

Overview

This document sets out our response to the Australian Energy Regulator's (**AER**)'s draft decision on forecast inflation adopted in the post-tax revenue model (**PTRM**).

1. AER draft decision

The AER's draft decision includes an estimate of expected inflation of 2.45%, which is higher than the 2.42% included within our 2020-25 Access Arrangement (**AA**) Proposal.

Despite our request that it reconsider its approach, the AER has estimated its inflation forecast as the geometric average of 10 annual expected inflation rates, resulting in forecasts significantly above observed inflation rates and market expectations. In our 2020 Plan, we recommended that the AER either adopt a glide path approach or a market based approach to lower the risk of the inflation forecast being out of sync with the rate of return expectations.

2. JGN's response to the draft decision

In the current market conditions we do not believe that the AER's approach produces a reasonable estimate of inflation, or provides JGN a reasonable opportunity to recover an efficient cost of capital. This has been demonstrated by analysis presented by the Energy Networks Australia (**ENA**), SA Power Networks (**SAPN**) and Queensland Treasury Corporation (**QTC**).[1]

The National Gas Objective seeks to promote efficient investment in, and efficient operation and use of gas services for the long term interests of customers. In support of these objectives, the Revenue and Pricing Principles set out in the National Gas Law allow investors a reasonable opportunity to recover efficient costs of investment. The regulatory models give effect to this by a nominal return on capital allowance and indexation of the regulated asset base (**RAB**) to compensate for funding investment. To avoid double compensation for inflation the regulatory models also remove indexation of the RAB through the regulatory depreciation building block. However, the regulatory models assume nominal cash interest payments to debt holders which means that the indexation of RAB compensation goes to the equity holders and therefore the entire reduction for indexation through the regulatory depreciation is from the return on equity.

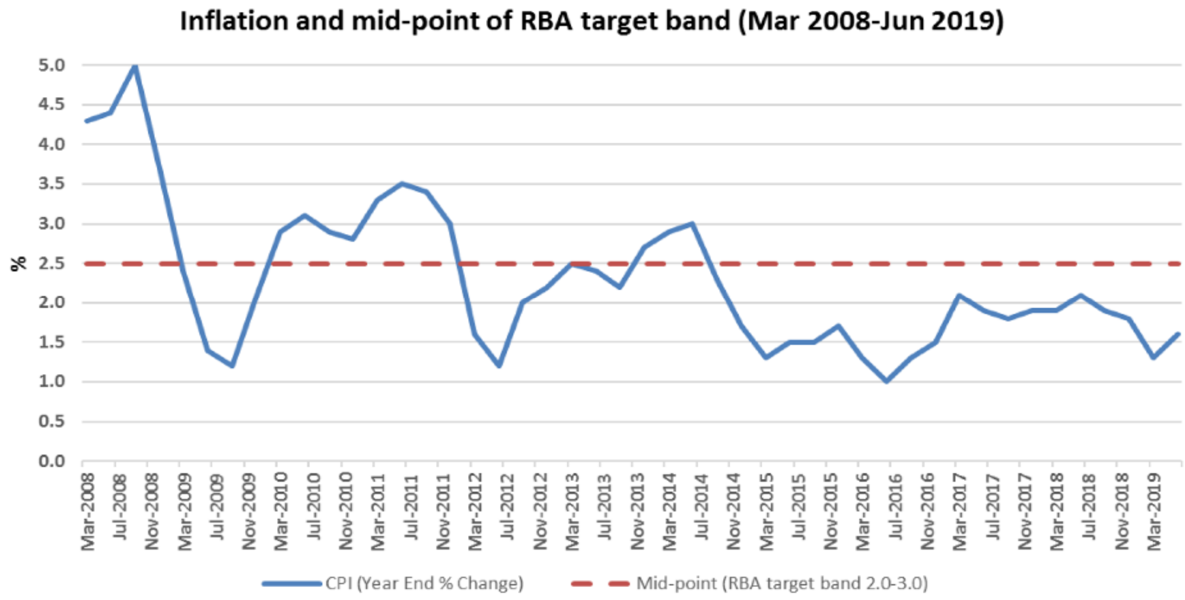
The equity holders will only receive cash dividends if the nominal return on equity allowance is higher than the indexation of RAB deducted through the regulatory depreciation building block. In the current market conditions the AER's 2018 Rate of Return (**RoR**) Instrument is delivering a very low return on equity of 4.6% in AER's draft decision for JGN, or a placeholder return on equity of 4.67% in our Revised 2020 Plan. If the AER was to reduce the return on equity using its inflation forecast approach (which delivers 2.38%) then the return on equity will need to be reduced by 5.95% (2.38%/0.4 where 0.4 is the benchmark equity portion of investment). This leaves no cash to be paid as dividends to equity holders as the 5.95% deduction is greater than the nominal return on equity allowance of 4.67% (4.67% - 5.95% = - 1.28%).

Such an outcome is inconsistent with the Revenue and Pricing Principles as it leaves the business in a loss making position and does not provide a reasonable opportunity to recover costs. It is difficult to comprehend why the AER would adopt an approach that does not allow for any cash dividends to be made to the equity holders for investing in such long life assets, which face significant asset stranding risks.

Figure 2–1 shows that actual inflation has been consistently below the mid-point of RBA's target band of 2% to 3%, since 2015.

[1] Estimation of Expected Inflation, 7 November 2019; Issues raised by QTC at the Inflation Working Group meeting, 9 Nov 2019; SAPN – 2020-25 Revised Proposal Attachment 3 Rate of Return

Figure 2–1: Actual inflation and RBA target band mid-point



In light of the above, JGN continues to advocate for the AER to reconsider its inflation approach which is currently penalising network businesses for a known upward bias in the forecasting approach compared with current market expectations.

The Economic Regulation Authority (**ERA**) in Western Australia, also in its 2018 RoR Instrument explanatory statement, rejected the AER's approach to inflation on the basis that the Reserve Bank of Australia (**RBA**) fixed target mid-point of 2.5% does not reflect changing inflation expectations and may result in overestimate of expected inflation. The ERA also noted that use of RBA's forecast can result in a negative real risk free rate which would deter investors from funding investments.[2]

The Independent Panel also endorsed ERA's approach of using a treasury bond implied inflation approach noting that ERA's approach is likely to be the best means of forecasting inflation, given its use of appropriate market information.[3]

Table 2–1 demonstrates that if the AER was to consider forecasting accuracy—which it has applied to compare the Deloitte Access Economics and BIS Oxford Economics WPI expectation approaches in JGN's draft decision on opex—then it will see that the market based methods such as break even and inflation swaps are more accurate in forecasting inflation expectations compared to the AER's geometric mean approach.

[2] ERA, 2018 Rate of Return Guidelines Explanatory Statement, para 1580-1583

[3] ERA, 2018 Rate of Return Guidelines Explanatory Statement, para 1585

Table 2–1: Accuracy of 3 and 5-year inflation forecasts compared to 3 and 5-year subsequent actual inflation

Source	3 year average mean absolute error	5 year average mean absolute error
AER inflation	0.56%	0.59%
Breakeven inflation	**0.37%**	0.44%
Inflation swaps	0.48%	0.61%
Average: AER and breakeven	0.39%	**0.41%**
Average: AER and swaps	0.50%	0.52%
Average: Breakeven and swaps	0.39%	0.43%
Average: All three	0.42%	0.45%
Lowest absolute error	Breakeven inflation	Average: AER and breakeven

Source: ABS, AER, Bloomberg, RBA, CEG analysis

The AER could consider either adopting a more market based approach in light of this, or even taking a conservative view of an average of its approach and a market based approach, both of which improve the forecasting accuracy. However, it must conduct a cross-check that its approach results in positive cash dividends for equity holders.

Even if the AER was to continue with its current approach it should consider updating the PTRM with actual inflation when updating return on debt annual observation to minimise inflation risk from forecasting inaccuracies.

3. Revised proposal inflation forecast

In light of industry concerns and subsequent to JGN's draft decision, the AER held a teleconference with the network businesses and is considering reopening an industry consultation on its inflation approach. Given that JGN's final decision may come either at the same time as the AER's decision on its inflation approach or subsequent to it, we propose that the AER applies the inflation decision to JGN's final decision or allows JGN to seek an update to its Access Arrangement post the final decision in accordance with Rule 65 of the National Gas Rules.

In our Revised 2020 Plan we have updated the placeholder forecast inflation of 2.38% applying AER's method.