Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
Canberra ACT 2601

By email: inflationreview@aer.gov.au

Jemena Electricity
Networks (Vic) Ltd
ABN 82 064 651 083

Level 16, 567 Collins Street
Melbourne, VIC 3000
PO Box 16182
Melbourne, VIC 3000
T +61 3 9173 7000
F +61 3 9173 7516
www.jemena.com.au

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Dear Warwick

Response to AER's Draft Position Paper on Regulatory Treatment of Inflation

We welcome the opportunity to comment on the Australian Energy Regulator's (**AER**)'s Draft Position Paper (**position paper**) on the regulatory treatment of inflation. We also appreciate the AER for holding several workshops to engage on the issue from the various stakeholders' perspectives.

The AER explored two issues in relation to regulatory treatment of inflation – the estimation method for forecasting inflation expectations and the regulatory treatment of inflation. The AER has proposed improvement to its current estimation method by adopting the use of linear glide path approach from the RBA's forecasts of inflation for years 1 and 2 to the mid-point of the inflation target band (2.5 per cent) in year 5. The AER considers that the estimation method addresses the key issues that have motivated submissions to change to a hybrid or nominal framework.

We agree with the AER that the 5 year glide path is an improvement to the current forecast method and makes Post-tax revenue model (**PTRM**) and Roll forward model (**RFM**) internally consistent and capable of delivering an NPV=0 outcome. The immediate implementation of this change in method significantly addresses the issue with the framework for us and removes the urgency to pursue any framework change.

We engaged CEG as our expert to review the AER's draft position paper and Dr Lally's advice to the AER. CEG has provided an expert report, the key findings of which are:[1]

1. The AER's proposed adoption of a 5 year inflation forecast (with a glide path) in the PTRM is logical and consistent with what is required in order to generate NPV=0 outcomes. This conclusion is entirely in agreement with the advice the AER sought from Dr Lally.

[1] CEG, Response to AER draft position paper on inflation, Nov 2020

2. There is no rational basis for delaying the implementation of this change to the PTRM inflation forecast because –

   a) The National Electricity (and Gas) Rules require that the best method is implemented and this must be a 5 year forecast (for reason provided in point 1 above). In addition, the AER's own reasoning establishes that a glide path is the best estimate.

   b) Implementing a delay would impose an expected windfall loss on Victorian NSPs (compensation lower than costs) equal to 0.35% pa based on the AER's own estimates.

   c) The AER's position paper already imposes a significant embedded delay because the AER forecasts cover the period 1 July 2021 to 30 June 2026. However, the RFM covering this regulatory period will use inflation from 1 January 2020 to 31 December 2025. Due to very low (actual and forecast) inflation in the 18 months from 1 January 2020 to 30 June 2021, Victorian NSPs already face 0.40% pa under compensation on their funding costs over 5 years – even with immediate introduction of the AER 5 year estimate.

   d) The Victorian NSPs decisions occur at a time of very low risk free rates causing very low cost of equity estimates (and these are potentially artificially lower due to RBA intervention in the long maturity end of the yield curve). This creates material financeability concerns even before consideration of the 40bp under compensation explained in the previous point. Imposing a further 0.35% pa would only place pressure on already strained financeability metrics.

With the benefit of CEG's review we recommend that the AER does not apply any transition or delay to adoption of the 5 year forecast using glide path approach. An immediate implementation of 5 year forecast inflation means that there is no urgency of framework change from our perspective.

Please contact me on [redacted] if you would like to discuss this submission further.

Yours sincerely

[signed]

Sandeep Kumar
Group Manager Regulatory Analysis and Strategy