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Dear Warwick

Submission regarding proposed financial models

Jemena welcomes the opportunity to further comment on the draft regulatory models that the Australian Energy Regulator (AER) has released for consultation on 5 December 2019.

During the earlier informal consultation phase, which included preliminary draft models, Jemena made a submission on 20 September 2019. In addition to some minor recommendations Jemena noted that the gas regulatory PTRM consultation should include consultation on how the inflation assumption should be applied. The key points regarding inflation from our previous submission were:

- There is a significant difference between the estimate from AER's method of using RBA target range and the actual inflation in current market conditions

- The regulatory framework should at a minimum deliver a target nominal return on debt because corporate debt is most efficiently raised using nominal debt instruments. Distribution Network Services Providers (**DNSPs**) are required to meet interest repayment in nominal terms irrespective of whether actual inflation turns out to be higher or lower than expected at the time they entered into the debt contract

- Some minor amendments to the PTRM will reduce the impact of forecasting error associated with inflation.

In response to our submission on 20 September 2019 the AER wrote a letter to Jemena on 7 November 2019 addressing the treatment of inflation within the PTRM and RFM models. In the letter the AER states:

- We recently concluded that we should maintain the current inflation compensation approach in December 2017, after a comprehensive review

- We examined whether the AER should target the delivery of a real return on capital, a nominal return on capital, or a hybrid approach that targets a nominal return on debt and real return on equity
    - We decided to maintain the existing target—that is, the delivery of a real return on capital plus outturn inflation. There was broad stakeholder agreement that the regulatory models delivered this rate of return target

- We do not agree that there is under compensation when using an approach that targets the real (not nominal) rate of return on capital

- We consider it is important to preserve a consistent inflation approach across gas and electricity in order to prevent investment distortions across the sectors

- The appropriate forum to continue to explore the matters raised in your letter is through the working group on expected inflation and low CGS yields.

Jemena participated in teleconferences with the AER as part of ENA inflation working group, however, the AER decided to defer its decision making to open up inflation issue to early 2020. This puts us in a difficult position as Jemena Gas Network (**JGN**) is expecting a final decision in April 2020 and we are currently not clear on AER's decision on inflation approach. Nevertheless we believe regulatory decision making should be agile to adapt to significant market movements rather than limit itself to time posts and Rate of Return Instrument processes. In the previous Victorian regulatory decisions the AER states expected inflation should be defined in the PTRM via consultation procedures[1]:

> *…As such, any change in approach should only be considered following broad consultation with all stakeholders….. Moreover, the method for estimating expected inflation is defined in the post-tax revenue model (PTRM) and changing this should be done in accordance with distribution consultation procedures..*

Given that the AER is reviewing the gas regulatory models including PTRM, there should be headroom to at least amend the inflation forecasting method which is used for indexation of RAB. Even if the AER does not want to move away from compensating for real rate of return it should look at adopting a method that aligns better with market expectations. This is because the AER's 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. Holding all else constant 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. The current market conditions necessitate, at the minimum, a rethink of the inflation forecasting method.

[1] 3-153 Attachment 3 – Rate of return | Jemena distribution determination final decision 2016–20

In the current market conditions the 2018 Rate of Return Instrument is delivering a return on equity of 4.6% in the AER's draft decision for JGN. If the AER was to reduce the return on equity using its inflation forecast (which delivers 2.45%) then the return on equity will need to be reduced by 6.13% (2.45%/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 6.13% deduction is greater than the nominal return on equity allowance of 4.60% (4.60% - 6.13% = -1.53%). 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. This issue has been demonstrated by analysis presented by the Energy Networks Australia (**ENA**), Jemena Gas Network (**JGN**), SA Power Networks (**SAPN**) and Queensland Treasury Corporation (**QTC**)[2].

The Economic Regulation Authority (ERA) in Western Australia, 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. 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.

To improve forecasting accuracy the AER could consider either adopting a market based approach, or a combination of its approach and a market based approach as demonstrated in JGN revised proposal[3].

Other than the above issue of inflation we have the following minor suggestions for the AER:

- The draft PTRM includes a separate macro on the 'WACC' sheet that copies the calculated Te and Td values from the 'Analysis' sheet. The instruction is to do this once the X factors have been solved. An alternative approach would be to include that macro within the X factor solver macro on the 'X factor' sheet. Doing so would avoid the risk that the model user fails to separately run the 'Set Te and Td' macro.

- The AER could consider making provisions in the model for capex relating to ancillary reference services for appropriate regulatory treatment such as tax

- The year-by-year depreciation tracking generally looks appropriate and consistent with the modelling developed for electricity networks. One shortcoming that may be JGN-specific is that the depreciation tracking module does not align with how JGN's capital base is rolled-forward over the 2015-20 period. Specifically, it does

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[2] Estimation of Expected Inflation, 7 November 2019; JGN Revised Proposal – Attachment 7.2 Response to the AER's draft decision – Inflation, January 2020; Issues raised by QTC at the Inflation Working Group meeting, 9 Nov 2019; SAPN – 2020-25 Revised Proposal Attachment 3 Rate of Return

[3] JGN Revised Proposal – Attachment 7.2 Response to the AER's draft decision – Inflation, January 2020, Table 2-1, page 8

not recognise that the capex timing assumption used for that period treats half of actual capex as being incurred at the start of the year and half at the end. Some changes would be needed to reflect this. We have tested this using the depreciation model included with JGN recently submitted revised access arrangement proposal.

We remain committed to working constructively with the AER and welcome any further queries in relation to the above feedback. If you wish to discuss this submission please contact Jerrie Li on [redacted] or [redacted].

Yours sincerely

[signed]

Sandeep Kumar
Manager Regulatory Analysis and Strategy