Inflation Adjustment to the Opex Model

Brendan Quach Senior Economist
Office +612 8880 4815
Mobile +61 410 522 040
Email Brendan Quach@houstonkemp.com
Address Level 40, 161 Castlereagh Street
Sydney NSW 2000

Andrew Kingsmill
Regulatory Expenditure Manager - TransGrid
180 Thomas Street
Sydney NSW 2000

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Dear Mr Kingsmill

Draft Decision - Inflation adjustment to the Opex Model

The purpose of this letter is to reply to the questions contained in your email dated 10 December 2014. Specifically, you asked us to consider the reasonableness of the AER's draft decision to use 15 month lagged inflation to convert TransGrid's base year opex (ie, 2012/13) to June 2014 terms.

We understand from reviewing the attached excel model (entitled, *AER Draft decision TransGrid transmission determination - TransGrid 2014 – opex model – November 2014.xlsm*), that the AER in converting TransGrid's nominal base year opex to June 2014 dollar terms has applied the annual CPI adjustments used to calculate TransGrid's annual revenue under the CPI –X form of control. We understand that these CPI rates were also used in the RAB roll forward model. In other words, to convert the 2012/13 base year opex to June 2014 terms the AER model uses:

- the change in the CPI reported for March 2012 and March 2013; multiplied by
- half the geometric change between the CPI reported in March 2011 and March 2012.

The AER's use of lagged inflation results in TransGrid's base year opex in 2012/13 being indexed by **3.31 per cent** to convert it to June 2014 dollars.

In our opinion, this inflation adjustment is wholly inappropriate for the objective of converting base year opex to June 2014 dollars. Specifically, this approach is inappropriate because it:

- ignores the change in prices that occurs post March 2013; and
- includes the change in prices that occurred in the year preceding the base year (ie, 2011/12).

The objective of the opex model is to calculate the inflation adjustment necessary to convert TransGrid's 2012/13 actual opex expenditure into June 2014 dollars. The inflation adjustment should therefore be an assessment of the inflation that has occurred between the 2012/13 year and 30 June 2014.

I note that the roll forward applies lagged inflation to ensure that the depreciation allowance removed from the RAB matches the revenues received in the MAR, which is calculated using lagged inflation. However, the adjustment of base year opex to real June 2014 dollars is not attempting to match revenues received by the TNSP during the 2009/10 to 2013/14 regulatory control period and so it would be inappropriate to use the form of lagged inflation used by the AER in its draft decision.

Kind regards

Brendan Quach

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