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Mr Warwick Anderson
General Manager, Networks Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

By email: InflationReview2020@aer.gov.au.
Cc:

Dear Mr Anderson

Re: Response to 2020 Inflation Review – Discussion Paper

Thank you for the opportunity to contribute to the AER's 2020 review of the regulatory treatment of inflation.

We endorse the Energy Network Association's (ENA) submission on this matter, which provides a detailed explanation of the broader issues and solutions in relation to the AER's approach to regulatory inflation.

This letter focuses on the impact of the AER's approach to regulatory inflation on our investments in Major Projects, which the Australian Energy Market Operator (AEMO) describes as "nationally significant and essential investments in the electricity system to ensure the system meets its security and reliability requirements with the least cost and lowest regret to consumers"[1].

Impact of AER's inflation forecast on investment

The AER's nominal return on equity is currently at a record low level of 4.56% per annum[2].

Investors who expect inflation to be lower than the AER's estimate of 2.3% per annum will expect to receive an even lower nominal return on equity than 4.56% per annum. For example, an investor who expects inflation to be in line with current market estimates of around 1.3% per annum (rather than the AER's estimate of 2.3% per annum) will expect a nominal return on equity of approximately 2.06% per annum[3]. This is significantly lower than the return allowed in the AER's Rate of Return Instrument[4] and does not provide businesses with a reasonable opportunity to recover their efficient costs. A lower return is likely to result in less investment than is consistent with the long-term interests of consumers.

As noted above, the ENA's' submission provides a detailed explanation of the issues and solutions in relation to the AER's current approach to regulatory inflation.

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[1] AEMO, Draft 2020 ISP, p. 6. Found at Link

[2] The real return on equity in the PTRM is 2.26%. This is the allowed nominal return of 4.56% minus the AER's expected inflation of 2.3%

[3] See ENA submission, in particular Table 2. Calculated as the real return on equity in the PTRM of 2.26% per annum *plus* the market expectation of inflation of 1.30% per annum (included in the RFM) *less* the subsidy to debt holders of -1.50% per annum.

[4] Nominal cost of equity of 4.56%

Impact on Major Projects

The impact of the low return on equity and the AER's approach to inflation is exacerbated by the amount of investment in the Major Projects required under AEMO's Integrated System Plan (ISP).

AEMO considers the Major Projects are necessary to expand and upgrade the transmission network in order to support the energy market transition and ensure reliable and affordable electricity supply to consumers. AEMO assesses Major Projects as delivering net market benefits, including lower prices for the National Electricity Market, and being in the long-run interests of consumers.

Subject to being financeable under the current regulatory framework, we expect to spend more than $3 billion on greenfield investment[5] over the next few years to deliver our share of the Major Projects, including the Queensland New South Wales Interconnector, Project EnergyConnect and HumeLink. This would be an unprecedented increase in capital expenditure on our network. To put this in context, the value of our regulatory asset base (RAB) was $6.4 billion (Nominal) at the start of our current 2018-23 regulatory period.

A key cause of the current financeability issue that we are facing under the National Electricity Rules is the practice of indexing the RAB. This defers revenue recovery until later in the investment horizon[6] so as to promote intergenerational equity, whereby current and future consumers pay a similar amount each year, in real terms. This approach makes sense for business-as-usual network investments, but it undermines the financeability of large greenfield projects. This is because revenues in the early years of projects, particularly during the construction phase, are insufficient to support their financing requirements.

For example, investment by us in a large greenfield project[7], funded on a 60/40 debt to equity model firm basis, would reduce our current credit metrics and likely lead to at least a one notch credit rating downgrade to Baa3 (equivalent to an S&P credit rating of BBB-), which is two notches below the AER's BBB+ / Baa1 benchmark. This rating would further increase the level of under-compensation arising from the difference between the efficient cost of investment and the AER's benchmark allowance for the rate of return. The current record low return on equity and the AER's approach to regulatory inflation, exacerbate this financeability issue.

Removing the requirement to index the RAB for Major Projects and implementing a reasonable approach to the return on equity and regulatory inflation are key steps in promoting efficient investment in the long-term interests of consumers. In particular, they are necessary to ensure the financeability of Major Projects.

Next steps

We look forward to continuing to work with the AER to address the challenges set out in this letter to arrive at an outcome in the long-term interests of investors and consumers. If you have any questions on this letter, please contact our Head of Regulation, Stephanie McDougall, on [redacted] or [redacted].

Yours sincerely

Jason Conroy
Chief Financial Officer

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[5] This investment is not business-as-usual (BAU)

[6] Indexation increases the value of investment in the RAB each year by inflation and removes that increase (i.e. indexation) from the revenue recovered via annual tariffs

[7] A hypothetical $2 billion project