29 July 2020

Mr Warwick Anderson
General Manager
Network Finance and Reporting
Australian Energy Regulator

By email: InflationReview2020@aer.gov.au.

Dear Mr Anderson,

Re: Discussion paper on the regulatory treatment of inflation

The Network Shareholders Group (**NSG**) is pleased to contribute to the AER's 2020 review of the regulatory treatment of inflation.

The AER's review is timely given the significant continued divergence between the AER's inflation forecast and out-turn inflation. This review provides the AER with an opportunity to ensure that Network Service Providers (**NSP**) have a reasonable opportunity to recover at least their efficient cost of capital by ensuring that its forecast methodology and revenue models operate effectively to deliver the returns outlined in the Rate of Return Instrument (**RORI**).

Responding to changes in market expectations of inflation

Given the divergence between the AER's forecast inflation, market expectations and out-turn inflation, equity investors under-recover against the AER's targeted real returns. This is primarily due to the AER adopting the midpoint of the RBA's targeted inflation range as a proxy for long term expectations of future inflation, which has not been the case in recent years, and is no longer the case. The AER's forecasting inflation error materially reduces equity returns below that provided for in the RORI and simultaneously increases risk of investing in the sector.

As equity investors, we expect the regulatory forecast of inflation to be fit for purpose and a best estimate, which is currently not the case. The size of this error has revealed a potential flaw in the operation of the AER's revenue models in giving effect to the RORI. We, the equity investors, are at the forefront of funding the energy system transformation required in terms of decarbonisation and stabilisation by policy makers and system participants. The issues raised here form part of the impediment to delivering the investment required by virtue of increasing risk, uncertainty and ultimately system cost.

The legislative and regulatory framework governs the rate of return and the treatment of inflation

The AER acknowledged the additional risk to equity investors of the interaction between the Post Tax Revenue Model (**PTRM**) and Roll Forward Model (**RFM**) in its 2017 review. This risk has continued to materialise and grow, and the current review presents an opportunity to rectify the situation.

While the previous framework may have provided the AER with the discretion to 'target' a return outside the rate of return guideline, the 2018 RORI is binding on both the NSP and the AER. We encourage the AER to demonstrate how the RORI is given effect when the AER can 'alter' the effective return in its treatment of inflation and supporting revenue models.

In the absence of merits and effectively judicial review, the AER is the only arbitrator for changing inputs to the RORI, including how inflation is forecast. Equity investors therefore expect the AER to operate the regulatory framework as intended.

We welcome the opportunity to work with the AER on resolving this issue

We rely on the ENA submission to illustrate the mechanical issues in the PTRM and RFM, as well as improvements in the inflation forecast methodology and how it should be addressed to ensure NSPs can recover the efficient cost of debt and equity. The changes proposed are symmetrical in operation and will therefore operate mutually to reduce exposure to forecasting error risk for both equity investors and consumers (i.e. network charges will more closely reflect actual purchasing power of consumers).

We also consider it is beneficial for this review to clarify the following issues:

- Debt is held in nominal terms and changing hedging policies for short term fluctuations from forecasting errors is costly and inefficient.
- Debt covenants and rating agency metrics are based on nominal debt and revenue in each year and are exposed to inflation forecasting errors.
- NSP's total annual revenues are exposed to inflation forecasting errors given the RAB is rolled forward by out-turn inflation while depreciation deduction is based on the AER's forecast inflation.
- In the 2018 RORI review, the AER considered that equity beta estimates used in estimating the required return on equity consider exposure to nominal debt and associated inflation risk. We do not agree with this assertion. Notwithstanding, even if this was the case, equity beta data covers a period when inflation linked debt products were available in a liquid market – these are not available now.

We look forward to working with you to develop a shared understanding of the issues and a resolution given the current regulatory framework governing rate of return issues, and the models that give effect to that framework.

If you have any questions or would like to discuss further, please contact Sally McMahon, Spark Infrastructure (phone 0421057821).

Regards,

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