

Level 17, Casselden
2 Lonsdale Street
Melbourne Vic 3000
GPO Box 520
Melbourne Vic 3001
tel: (03) 9290 1800
www.aer.gov.au

Our Ref: 65487
Contact Officer: Scott Haig
Contact Phone: [REDACTED]

7 November 2019

Robert Stobbe
Chief Executive Officer
SA Power Networks
GPO Box 77
ADELAIDE SA 5001

Dear Mr Stobbe

Re: Regulatory treatment of inflation - Request for review

Thank you for your letter dated 20 September 2019 which raised concerns and requested the immediate commencement of a new inflation review, including a review of the post-tax revenue model (PTRM) where our approach to estimating expected inflation is specified.

As you note in your letter, the AER's current approach (the 'RBA approach') to estimating expected inflation over a 10 year horizon is predicated on the RBA's commitment to target inflation in line with its 2 to 3 per cent target band. The 'RBA approach' uses the RBA's short term inflation forecasts (for years 1 and 2) and the mid-point of the RBA target band (i.e. 2.5 per cent) for years 3 to 10, taking a geometric average across the ten yearly figures.

We most recently concluded that this is the best approach to estimating expected inflation for regulatory purposes in December 2017, after a comprehensive review. Since that time, we have been monitoring the approach in accordance with the commitment we made in our December 2017 final position. In particular, we have been monitoring survey evidence on long term inflation expectations using the Consensus Economics survey. In our view, this data, including the most recent data for July and October, does not suggest that longer term inflation expectations have departed from the RBA target band. Expected inflation from year 3 to year 10 is close to 2.5 per cent, the mid-point of the target band. However, we will continue to monitor the data and what implications it could have for our implementation of the RBA approach.

We have also considered the issues you raised more specifically in your request for the commencement of a new review.

You note that measures of expected inflation derived from indexed bonds and swap rates have diverged from the RBA target band. In our 2017 review, we considered the use of these measures in some detail. We identified a number of biases in both indexed bond and swap based measures of expected inflation. These biases, such as inflation risk and liquidity

premiums, were substantial and time varying. Moreover, we were advised by the RBA at the time that 'market-based measures of inflation expectations have several shortcomings that probably make them unviable alternatives to the current method'. We consider the limitations of these alternative approaches remain, noting that evidence has not been provided that indicates these biases have been addressed.

There has been constructive engagement with SA Power Networks—as well as a broader set of network, investor, retailer and consumer representatives—through the working group on expected inflation and low CGS yields. In our view, that working group is the appropriate forum to continue to explore the matters raised in your letter, consider additional material from SA Power Networks and for us to provide updates on our ongoing monitoring activities. The working group can also consider material from other stakeholders, such as the material we expect to receive from the ENA, and allow stakeholders to discuss the implications of this material.

We remain focused on achieving outcomes that are in the long term interest of consumers. This includes the provision of a regulated rate of return that will provide an incentive for efficient investment in energy networks. We acknowledge that, in an environment of low interest rates and low bond yields, it is important that we carefully monitor our regulatory approach and we will continue to do so.

If you have any questions, please contact Mr Scott Haig, General Manager (acting), Networks Finance and Reporting, on ([REDACTED]) or via [REDACTED]

Yours sincerely

[REDACTED]

Clare Savage
Chair
Australian Energy Regulator

Sent by email on: 07.11.2019