AUSTRALIAN ENERGY REGULATOR

Minute: Inflation Working Group Meeting

Date: 28 November 2019

Participants

AER staff

Warwick Anderson, Ben Stonehouse, Esmond Smith, Shaun Collard, Kevin Fincham, Scott Haig, Paul Dempster

External participants

Garth Crawford (Energy Networks Australia), Patrick Makinson (SA Power Networks), Mark de Villiers (Citipower, Powercor and United Energy), Sandeep Kumar (Jemena), Nick Wills-Johnson (Australian Gas Infrastructure Group), Jon Hocking (Endeavour Energy), David Johnston (Queensland Treasury Corporation), Mark Grenning (Consumer Challenge Panel), Bev Hughson (Consumer Challenge Panel), David Havyatt (Energy Consumers Australia), Patrick Whish-Wilson (AGL)

Purpose

The Inflation Working Group met to discuss developments and to look at more recent material provided by the ENA on November 7th.

All material presented at the Working Group session is available on the AER's website.

Agenda

Item	Session title	Time allocated
	Introduction	10 mins
1	Compensation target	30 mins
2	Best estimate of expected inflation	30 mins
3	Exploring the ENA's additional material	40 mins
4	Next steps	10 mins

Agenda item 1: Compensation target

Issue 2 of the 2017 review focused on whether the framework appropriately compensates for inflation. There were two sub-issues on this topic: firstly, does the current approach provide an ex-ante real return? And secondly, should it target something else?

AER staff gave a brief introductory presentation on our findings in the 2017 review, and our views on material submitted up to Nov 7 on the compensation target.

Participants and AER staff then discussed issues including:

- The distinction between ex-ante and ex-post outcomes. Differences between expected inflation outcomes and actual inflation outcomes do not mean that an ex-ante expectation of future inflation was incorrect *when it was made*.
- That it is important to look at the combined effects across the PTRM, RFM and pricing; as well as across multiple reg periods.
- The interaction between Issues 1 and 2, noting that under the current framework, a biased estimate will lead to incorrect compensation over the long-term.
- The desirability of a stable and predictable regulatory framework, and that stakeholders widely accepted this as a consideration in the 2017 review.
- How the current framework would deal with a negative inflation risk premium; given the current low level of nominal CGS yields, participants raised concerns about the impact of inflation risk premia. This is discussed in more detail in the QTC note provided after the session and published alongside this minute.
- Where inflation risk ought to sit in the context of regulatory finance. Under the current framework that risk is with the businesses, with equity holders specifically.
- An option under which networks could purchase inflation swaps under their opex allowances. Participants recognized that this would change the current risk allocation.

Agenda item 2: Best estimate of expected inflation

Issue 1 of the 2017 review focused on the best approach to estimate investors' expectations of 10 year inflation. In the 2017 review we considered four options, being:

- The (current approach) RBA method, under which we rely on RBA forecasts over two years then the mid-band of the RBA's inflation target for years 3-10. We considered a glide-path variation on this approach.
- Market-based approaches, using:
  - The bond break-even approach (difference between indexed and unindexed CGS yields); and
  - Inflation swaps.
- Surveys.

AER staff gave a brief introductory presentation on our findings in the 2017 review, and our views on material submitted up to Nov 7 on the best estimate of expected inflation.

Participants and AER staff then discussed issues including:

- That a systematically biased estimate of expected inflation would result in incorrect compensation over time.
- Whether the RBA strictly targets the mid-point of the inflation targeting band, or simply inflation falling within the band.
- Where within the inflation targeting band inflationary expectations are anchored. Outcomes are materially different if expectations are anchored at the bottom of the band compared to the middle or top of the band.
- Estimated bias in the Bond Break Even approach relative to the RBA method and the extent to which this has changed since 2017. Participants discussed findings of the 2017 review with respect to whether this bias is time-varying.

- Any refinement to the RBA's processes does not necessarily imply that there is an issue with their current methodology, and such continuous re-evaluation and improvement is appropriate.

Agenda item 3: Exploring the ENA's additional material

ENA representatives presented a brief summary of the slides included in its slide-pack, after which participants had an opportunity to give preliminary views on the issues.

Participants and AER staff then discussed issues including:

- Questions about the data on inflation excursions outside target bands. Confirmed that the data is based on the RBA's public CPI series, that it commences in 1995 roughly contemporaneous with when formal inflation targeting was introduced (1993) and formally endorsed (1996), and that there had been 10 excursions outside of the target band from which the average was drawn.
- Whether the 2017 review included analysis of the time to revert to the midpoint of the RBA target band, and the implications of the ongoing excursion since the review.
- The implications of the NPV=0 criteria. Participants suggested that for this excursion from target band to average-out over time, inflation would have to spend five years above 3%
- Whether the RBA's ability to return to the target band is symmetrical; specifically whether it is easier to move down into the band than to move up into the band,
- Other policy levers beyond monetary policy which could be deployed to increase inflation. On that basis, some participants recommended that we should be careful about making changes based on expectations of the impact of monetary policy alone.
- The impact of staggered five year determinations under which any review or methodology change would apply to the next resets, but not to preceding ones. Participants also discussed the impact of decision timing on investment incentives.
- Consumer advocates noted they had not yet had sufficient time to engage with the material in order to form a considered position.

Agenda item 4: Next steps

AER staff briefly discussed next steps for consideration of the material put before the AER.

Participants then discussed the potential scope of a review if one were to occur. Participants discussed a range of views, including that:

- It is important to have a clearly defined scope in order to commence a review
- Conversely, that it is inadvisable to narrow potential responses before a review commenced
- That, failing a full review, there is a simpler option of a 'light touch' review, whereby some kind of mechanism would be introduced to prevent negative net profit after tax outcomes (arising from the impact of inflation on regulatory depreciation) in the PTRM.