# AER: Inflation review 2020
# Our final position

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# Welcome

- Confidential briefing
- Timing of release of final position
- No Q&A session as part of today's briefing
- Briefing will outline:
  - our final position
  - commentary on key reasons
  - next steps in this review.

# Scope of the review

It is our role to ***determine a method that is likely to result in the best estimates of expected inflation.***

- We have therefore considered:
    1. What method should we use to estimate expected inflation?
    2. Does the regulatory framework successfully deliver the expected real rate of return under the current approach?
    3. Should we instead target a nominal or hybrid return?

# How long should the inflation term be?

**Inflation compensation over a regulatory period* =**

| 10 year inflation expectations (implicit in rate of return) | − | ? year inflation expectations **(best estimate in PTRM)** | + | 5 year outturn inflation (added to asset base in RFM) |
|---|---|---|---|---|

*Abstracting from smaller inflation impacts such as on opex, the first year pricing effect and any inflation premia present in the set rate of return.

The options:

- Match rate of return Instrument (10 years)
- Match regulatory control period (usually 5 years)

It is not possible to match both, thus causing a mismatch. Based on our current data, the potential mismatch is equivalent to 0.35 per cent.

# Why are we adopting a shorter inflation term?

- Dr Lally’s analysis suggested targeting asset inflation was more appropriate than targeting the term of the rate of return.
- Allows for greater alignment in expectation of the revenues to debt costs and potentially lower financeability risks for service providers.
- Of the view that this better aligns incentives for efficient investment (which is in the long-term interest of consumers).

**Final position: match regulatory control period**

# Do we need to transition to shorter inflation term?

We considered the possibility of transitioning to a shorter inflation term.

- A change in inflation term will create a one-off impact on service providers and consumers for revenues and prices charged.
- Consumer representatives were concerned that immediately applying the change may not be in the long-term interest of consumers.

We have decided to immediately apply the shorter inflation term.

- The benefits of moving to a shorter inflation term are implemented sooner.
- Current market conditions illustrate that the mismatch is material.
- Even if implemented immediately, changes to expected inflation term will take time to flow through as they are built into each determination (typically 5 years).

**Final position: a transition is not necessary**

# Method to estimate expected inflation: Indicators

- RBA short-term forecasts vs. market-based measures.
- Deloitte and Dr Lally found that market-based measures were affected by the presence of material and time varying distortions that limit their use in a regulatory context.
- RBA commentary that market-based measures are volatile in current environment.
- RBA best placed to understand, and balance available material when developing its forecasts.

**Final position: RBA short-term forecasts**

# Method to estimate expected inflation: Glide-path

- Broad support for a glide-path
- We examined various other forms of the glide-path proposed in submissions.
- Adopted a simple linear glide-path because it aligns better with available data on the likely path inflation expectations over time.
- Glide-path provides a better, more enduring basis for estimating inflation expectations across changing economic circumstances.

**Final position: Simple linear glide-path to 2.5% in year 5.**

# Stakeholder impacts: Scenario

| Method | Estimate of expected inflation |
|---|---|
| Current term (10 years) with RBA forecasts of inflation of 1.25% in year 1 (2021-22) and 1.75% in year 2 (2022-23) | 2.30% |
| Proposed term (5 years) with glide-path and with RBA forecasts of inflation of 1.25% in year 1 (2021-22) and 1.75% in year 2 (2022-23) | 1.95% |

Adopting 1.95 per cent for our draft Victorian distribution determinations would result in approximately:

- an extra $300 million ($real 2021) in allowed revenue (across all Victorian distributors) over the next five years (out of total revenue of $10 billion approx. 3% higher revenue.
- around $8 more per annum on a (Victorian) customer's bill than using the current method—holding all else constant.

# What is our regulatory framework targeting?

The different options available:

- Real return regulatory framework
  - Returns to investors and prices for consumers are maintained in real terms
  - Precedents for this approach
- Hybrid and nominal framework
  - Lack of consumer engagement and demonstration of consumer value
  - Consumer groups did not support a change

**Final position: target a real rate of return**

# Implementation and indicative timeline

**Final position:**

Target a real rate of return, immediately apply an inflation term that matches the regulatory period, with a glide-path (using RBA short-term forecasts) to 2.5% in year 5.

| Step | Date |
|---|---|
| Publish final position paper and commence consultation on PTRM amendments | 17 December |
| Stakeholder submissions on proposed PTRM amendments close | 3 February 2021 (at least 30 business days to consult) |
| Final decision and amended PTRMs published | 16 April 2021 (no more than 80 business days from commencement of consultation) |
| Updated PTRM applied to final VIC electricity distribution determinations | Due 30 April 2021 |