

**AER Public Inflation Forum: Discussion summary**

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| Matter name: | Australian Energy Regulator (AER) Public Inflation Forum | | |
| Date: | Wednesday 14 June 2017 | | |
| Time: | 9:00am to 1:00pm | | |
| Location: | Stamford Plaza Sydney Airport  24 1 O’Riordan St,  Mascot NSW 2020 | | |
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| Phone to | Phone from | Meeting | Other |

*Note: This document provides an overview of the main points discussed during the AER Public Inflation Forum. Its use is purely informative. Stakeholders may use the information in this document to assist them in their submissions to the AER, due 29 June 2017.*

The Australian Energy Regulator (AER) held a public forum as part of its industry-wide consultation and review of the regulatory treatment of inflation. The forum gave stakeholders the opportunity to seek clarification of inflation-related issues in our previously published Discussion paper and allowed the AER’s project team to engage with stakeholders to understand their main concerns. The forum also provided the opportunity for all stakeholders to understand each other’s issues, concerns and potential consequences of changing the AER’s current approaches to treating inflation.

**Discussion Paper – key inflation related issues**

There was consensus that there are two broad inflation-related issues, both of which were raised in the AER’s Discussion Paper. These were categorized into:

* whether our method results in the best estimate of expected inflation
* potential mismatch between the best estimate of expected inflation and actual inflation outcomes.

There was agreement that the AER’s current method to estimating expected inflation has been used for some time. It is largely based on the midpoint of the Reserve Bank of Australia’s inflation target band, with weight given to the RBA’s available forecast over the short term, generally a two year period.

The second issue relates to potential mismatch between the best estimate of expected inflation and actual inflation outcomes. The underlying question is whether the regulatory framework provides regulated businesses with appropriate compensation for inflation, with particular reference to the treatment of inflation in the post-tax revenue model and the asset base roll forward model.

It was suggested that making a change to the treatment of inflation may have implications for the risks faced by consumers and regulated businesses, the level of returns commensurate with those risks, and whether network costs are recovered from consumers more towards the beginning or the end of the asset’s economic life. Changing risk profiles will necessarily impact on the efficient allowed rate of return and consideration must be given to consumers.

There were different views on which issues could be resolved more efficiently than others. There was strong consensus that both issues need to be addressed and analyzed.

**Best estimate of expected inflation**

Some stakeholders expressed a lack of confidence in the current method used to derive the best estimate expected inflation, and suggested that the current method does not adequately take into account the current low inflation environment. Therefore, some stakeholders were keen to have a method that incorporated current market conditions. They questioned whether the current method is ‘fit for purpose’.

*Criteria to assess approaches*

There was discussion regarding the criteria used to assess different approaches to estimating expected inflation. There was agreement that the relevant criteria are: (1) congruence with the regulatory framework, (2) congruence with the market expected inflation, (3) robustness and (4) transparency and replicability.

There was discussion about whether or not to take into account ‘simplicity’ as a criterion. There were differing views. However, most stakeholders were of the opinion that the criterion of ‘replicability’ incorporates the concept of simplicity and that complex measures should be considered if appropriate.

*Approaches*

There was discussion about academic evidence that inflation expectations may be anchored to the RBA’s inflation target, and the contrasting volatility of the bond break-even approach and inflation swaps approach. Using daily data, the bond break-even approach and inflation swaps approach both appear considerably more volatile than the AER’s current method. As a result, there was some discussion about the extent to which volatility differs between the methods and questions were raised about volatility differences when using quarterly or daily data.

There was some discussion on the use of inflation swaps as an approach to estimating expected inflation. Some stakeholders noted that there may be some disadvantages with the use of inflation swaps. These potential disadvantages include the costs involved for network service providers, the thin market in which they operate inflation risk premia and inflation indexation lag. The CCP Sub-panel advocated further investigation into swaps and suggested that the potential issues may not be material.

There was discussion about other approaches to estimating expected inflation such as the glide path approach. Additionally, there was discussion on different case studies. These included consideration of the approaches used by Ofgem, Ofwat, New Zealand Commerce Commission, IPART and ERA. There was agreement that agencies use different approaches and there is no clear consensus.

*Investors*

There was some discussion about the need to focus on the returns to investors, what investors do to manage risk, and how they invest. Some stakeholders noted that rational investors would likely invest based on real return benchmarks given the relatively long lives of regulated assets.

There was some agreement that the AER should be asking investors about how they make decisions and which best estimate of expected inflation they most likely use.

*Value of stability*

There was consensus that having a settled approach to estimating expected inflation is important. There was discussion about what stability is and whether or not the criterion of robustness incorporates stability. There was also discussion about whether stability reflected the anchoring of inflation expectations to the RBA’s inflation target.

Some stakeholders questioned whether some volatility in inflation estimates is desirable as an offset to volatility in the nominal rate of return. Some raised the idea of weighing different approaches. That is, weighing each approach to estimate the expected inflation and placing them in the most appropriate order.

**Mismatch between expected inflation and inflation outcomes**

Overall, the main discussion centred on whether the regulatory allowance, set up front, should be denominated as:

* + final nominal value of revenue / price?;
  + real value of revenue / price with an inflation pass-through?;
  + some hybrid of real and nominal?

Some stakeholders raised the idea of a hybrid allowance being a combination of real and nominal. That is, cost of debt being in nominal terms and cost of equity being in real terms.

*Modelling interactions and real versus nominal*

It was discussed that a move away from an overall real return may increase inflation risks and change investors’ required returns. This could end up causing higher or lower prices for consumers.

There was also some discussion that there may be a preference to receive set dollar (nominal) value returns, as perhaps investors and analysts set their targets in nominal terms. As a result, some stakeholders thought that if this were the case then investors may want to receive set nominal returns.

Most stakeholders agreed that if the best estimate of expected inflation did not change network service providers would have more buy-in regarding how to approach the mismatch between expected inflation and inflation outcomes.

There was discussion about the inflation measures used in the Post-Tax Revenue Model (PTRM) and those used in the Roll Forward Model (RFM). The RFM deals with actual inflation and the PTRM deals with expected inflation. Some stakeholders noted that they did not fully understand the interactions between the PTRM and RFM. There was consensus that there needs to be more demonstrations given by the AER about how these models interact and how the CPI – X methodology operates.

*Finding a key understanding of change*

Most stakeholders agreed that there needs to be a key understanding of what needs to be changed. There was a view that the AER should only implement a change to its regulatory treatment of inflation after identifying what outcomes are sought from this treatment, whether what is currently in place actually achieves those outcomes, the significance of areas where desired outcomes are not achieved and the level of change required.

*Management of inflation risk*

There was discussion about how network service providers manage inflation risks and whether consumers pay the networks to bear inflation risk (and whether consumers still bear the risk). There was agreement that there needs to be quantitative demonstrations that revenue and price modelling provides the appropriate compensation for inflation. Also stakeholders were of the view that the AER needs to demonstrate that there is an efficient allocation of inflation risk between networks and end users.