AER Consumer Reference Group

Bulletin two

Update on the AER's treatment of inflation in setting the allowed revenues for network service providers

Over the past few months, the Australian Energy Regulator (AER) has been reviewing how it treats inflation when it calculates energy networks' revenue allowances. This includes how the AER estimates investors' expectations of future inflation. This is not quite the same as the AER trying to forecast future inflation. Although these estimates are one of the most obscure elements of the regulatory framework, they can have a significant impact on consumers.

The AER's current approach to estimating expected inflation has been in place since 2008 and has contributed to networks earning at least sufficient revenue for efficient investment. However, this review was initiated by the AER because it was concerned that it was over-estimating the value of investors' expectations of inflation in the current economic circumstances and this may result in consumer prices and network revenues that were too low. In response, it proposed a new methodology that, for now, would lead to lower estimates of inflationary expectations and higher prices for consumers. (AER draft position).

We responded with a submission demonstrating the AER's proposal was inconsistent with its overall approach to regulating prices. We expressed concerns that its draft proposal would raise energy prices and undermine consumer confidence in the regulatory framework, and would do so at a time when consumers are widely concerned with the affordability of energy services. These views aligned with concerns expressed by consumer advocates during our interviews with them. (CRG submission on AER draft position).

On 17 December 2020, the AER released its final position paper. It's not the outcome we'd hoped for, nor does it reflect the preferences of the consumer advocates we were able to interview.

The AER's final position paper reaffirms its draft position. Most importantly, this will see the AER estimate expected inflation over a five-year period. This will replace the 10-year outlook it has used for many years, which was consistent with the AER's emphasis on estimating investor real returns over the life of the assets. In practical terms this means the AER will now estimate a nominal rate of return over 10 years, but expected inflation and real returns over 5 years.

We remain concerned about the incompatibility of blending two different estimation periods to produce the applicable real rate of return, and the costs this could impose on consumers. This is why the CRG recommended the AER postpone its decision on expected inflation until the completion of its review of the rate of return in late 2022, when all these factors could be considered together. The

AER's final position paper indicates the AER will investigate the estimation period for the nominal rate of return during its 2022 review of the rate of return instrument.

The impact of this decision will be felt first by Victorian electricity customers when the AER makes its 2021-26 Victorian network determination next year. The AER estimates that the impact on Victorian consumers will be over $300 million ($real 2021), compared to continuing with the current method it has used since 2008. The AER's decision on expected inflation will also flow through to price increases in all its subsequent regulatory decisions on network revenues across the National Energy Market (NEM).

While we consider the term of the estimation of expected inflation has a significant and immediate impact on consumers, the CRG supports other aspects of the AER's decision. These include the introduction of a symmetrical glide-path, and the AER's rejection of proposals by some stakeholders to adopt a market-based measure of expected inflation and to move to a nominal or hybrid approach to the rate of return.

Therefore, despite our disappointment in some aspects of the AER's decision, we thank the AER for considering our views and the concerns expressed by consumers. We look forward to working with the AER, consumers and other stakeholders in the continuing review of the overall rate of return.

We would like to hear from you

We are most grateful to the cross-section of consumer representatives who have made very valuable contributions to our submissions to date. We are also aware that they are only a few of the many consumer representative organisations that have an interest in the outcome of these reviews, and that there is a diversity of views across the different organisations that represent consumers.

If you would like to know more about the AER's rate of return and inflation reviews and how consumers may be affected, or if you would like to know more about our upcoming work, we would like to hear from you. You can get in contact with us here.

Kind regards

Craig Memery (CRG Chair)

Allan Asher

Helen Bartley

Ron Ben-David

Joanne (Jo) De Silva

Kieran Donoghue

Beverley Hughson

Lynne Gallagher (Energy Consumers Australia representative)