AER Consumer Reference Group

Review of inflation 2020

Ever noticed that every year your train ticket costs more?

Inflation can be described as the changing value of the dollar. Inflation is a general measure of an increase in prices and fall in the purchasing value of money.

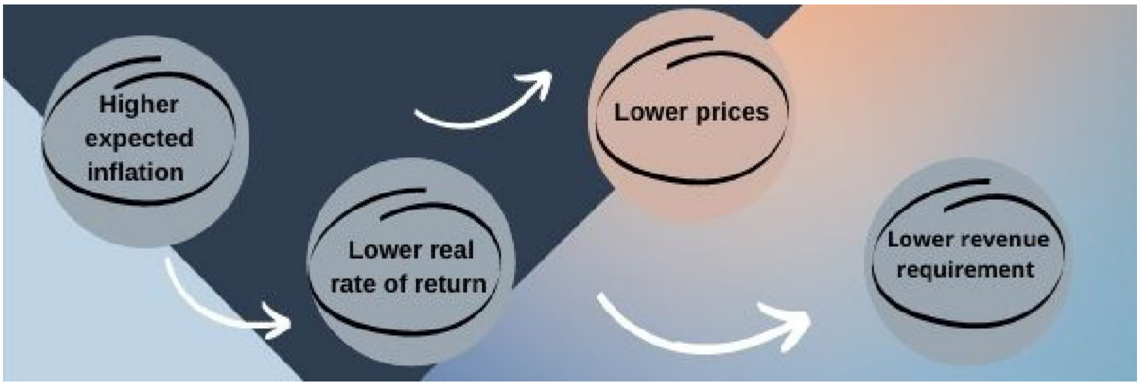
The Australian Energy Regulator (AER) sets a cap on how much revenue energy networks can recover from consumers. As part of setting this cap, the AER allows for inflation, both actual and expected.

Why is the AER reviewing inflation?

Expected inflation impacts on how much revenue energy networks can recover.

Recently, actual inflation has been consistently lower than the AER's estimate of expected inflation. If actual inflation remains low but the AER's estimate of expected inflation stays relatively high, energy networks will recover less revenue.

The figure below illustrates the relationship between expected inflation, the rate of return, prices and revenue.



Less revenue recovered by the businesses can lead to underinvestment because of the relationship between the regulated rate of return and market risk. In the short term, consumers may enjoy lower prices, but in the long term, there could be reductions in the quality of service and price instability.

Consumer Focus

The AER is examining a change to the methodology to estimate expected inflation. The AER is also considering whether an expected inflation model is still required. These two questions are considered below:

1. A change to the methodology to estimate expected inflation could lead to higher prices than under the current methodology (modelling can indicate the materiality of price

increases). If the methodology is unchanged, network businesses argue that they may be unable to continue to attract the necessary investment to maintain service quality.

2. If the AER decided to use a different model which does not estimate expected inflation when setting the future revenue requirement, this could lead to higher prices in the short term. In the long run, under some scenarios, it may result in more predictable prices for consumers.

Questions for consumers

1. If a change in methodology leads to higher prices, should this impact be smoothed out and if so, how? For example, could the new methodology factor in a gradual transition?

2. If a change in models resulted in price shocks, are there transitional arrangements that could be put in place to protect consumers?

3. Do consumers prefer stability in prices so that they can predict the proportion of their bill relative to income – or do consumers prefer stability in terms of predictable bills from year to year?

4. How important is stability for consumers relative to higher or lower prices?

More Info

The AER has set up a Consumer Reference Group to work with them on the Review of Inflation. The Consumer Reference Group has nine members from diverse backgrounds. Members of the Consumer Reference Group welcome discussion of these questions with you. You can contact us at InflationReview2020@aer.gov.au