29 June 2017

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601
via email: rateofreturn@aer.gov.au

Response to AER Discussion Paper – Regulatory Treatment of Inflation

Dear Mr Anderson,

Energy Networks Australia welcomes the opportunity to make a submission to the Australian Energy Regulator (AER) in the context of its recent Discussion Paper *Regulatory Treatment of Inflation* (Discussion Paper).

We welcome the AER providing stakeholders this opportunity to submit into a structured broader exploratory discussion of the estimation approach to expected inflation, and the treatment of inflation under both the Roll-forward Model (RFM) and the Post-tax Revenue Model (PTRM).

As the Discussion Paper notes, a number of network businesses have raised alternative approaches to the estimation of expected inflation as an issue in recent regulatory proposals, and ENA members actively sought a public consultation process such as the current review to determine a clear way forward.

Method for determining a best estimate of expected inflation

It is appropriate for the AER to be reviewing its approach given significant and sustained differences between:

1. market-based measures of expected inflation and the existing AER approach; and
2. expected inflation under current AER approaches and actual out-turn inflation.

The issue of reaching a best estimate and the issue of any regulatory framework adjustments or 'true up' for divergences between actual and forecast are linked. This is because reaching the best estimate of expected inflation that is practically possible will help reduce the size of potential divergences between expected inflation and actual inflation.

ENA's focus is on ensuring network charges reflect efficient costs and ensuring businesses have an ability to recover those costs. In particular, network businesses want to ensure that estimation approaches are sound to avoid any 'lottery' style outcomes for customers, i.e. circumstances where customers' charges are unduly impacted by arbitrary factors such as the period in which the estimate of expected inflation is made. Linked to this, there is a need to ensure expected inflation estimates are 'fit for purpose' for current unusual macroeconomic and monetary policy environment and robust to plausible futures.

Energy Networks Australia has commissioned Cambridge Economic Policy Associates to provide their advice on assessing the best approaches to estimating market expected inflation. Please find attached a copy of their report (Attachment A). This report also seeks to respond to a range of issues raised and discussed around alternative estimation approaches at the AER's June public forum.

The CEPA report finds

> *Based on an assessment against our chosen criteria, for which we place the greatest weight on market expectations of inflation that are congruent with the regulatory frameworks, we do not consider that the AER's current approach (i.e. using two years of inflation estimates and the mid-point of the RBA's inflation target range for eight years) represents the best estimate of market expected inflation. In particular, we do not consider that the current approach necessarily reflects macroeconomic conditions that the market based approaches take account of.*
>
> *Our preferred option is breakeven inflation, without an adjustment. This approach aligns with the regulatory framework, is a market based approach, and is supported by regulatory precedent in Australia and internationally. In our opinion, there are transparent and relatively accessible data sources, and methods that can be used to calculate breakeven inflation.*
>
> *We agree with the ACCC/AER conclusions that breakeven inflation estimates are not free from distortions from bias and risk premia. However, the evidence points to distortions varying over time and in direction and magnitude, therefore at any point in time the estimates may over- or under-estimate inflation. Therefore, an argument can be made that if the market based approach is used consistently over a long period the distortions may 'average out'. We do note that the evidence suggests that on balance breakeven inflation approaches may overestimate rather than underestimate inflation. This does reinforce concerns with the current method given breakeven inflation has been significantly below the mid-point of the RBA target for the past two years.*

Should the AER determine not to alter its existing approach of primary reliance on the mid-point of the RBA inflation estimate, the CEPA assessment also explores useful improvements that could be made to the current approach.

In particular, an approach that featured a more gradual reversion towards the mid-point of the RBA inflation band would better reflect both market estimates of expected inflation and historical evidence that mean reversion occurs over a longer period than the two years currently provided for in the existing RBA-based approach.

Treatment of inflation in the regulatory framework

The AER public forum highlighted that there were differing understandings between stakeholders on the actual operation and interaction of the treatment of inflation through the RFM and PTRM. There was broad agreement that there needed to be a shared understanding prior to any solutions being implemented.

Further collaborative work between ENA members, AER, the Consumer Challenge Panel and other interested stakeholders should be prioritised to establish a common base of understanding of the issues above, as a first step prior to any detailed development of any potential framework or rule remedies.

There are many different options for changing the treatment of inflation in regulatory framework. Any changes would need to be carefully evaluated. In designing any changes, there would need to be a focus on outcomes needed. Energy network businesses consider the critical outcomes are transparency, predictability and the avoidance of unnecessary volatility in network charges. The goal of avoiding unnecessary volatility in network charges is consistent with the recent movement, for example, to use of a trailing average cost of debt approach.

Customer confidence and symmetry in any changes is important. For example, one option to consider for any further action in this or any changed inflation estimation approach, would be deferring of the commencement date of any changed approach could ensure any change is clearly symmetrical and forward-looking.

ENA and its members look forward to continuing to engage collaboratively with the AER to more fully consider the issues raised in this letter and attached report beyond the Discussion Paper. We would value opportunity for further broader discussions with AER and other stakeholders on potential options to address them in future determination processes.

If further information is sought on this matter, please contact Garth Crawford, Executive Director, Economic Regulation, on 02 6272 1507.

Yours sincerely

John Bradley
Chief Executive Officer