29 July 2020

Warwick Anderson
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Dear Warwick

DISCUSSION PAPER: REGULATORY TREATMENT OF INFLATION

In May 2020, the Australian Energy Regulator (AER) released a discussion paper on the regulatory treatment of inflation. The discussion paper explores both the treatment of inflation in the current regulatory framework as well as the method that is likely to result in the best estimate of expected inflation. In addition, in July 2020, the AER published three reports prepared by Sapere, Deloitte Access Economics and Dr Martin Lally which further explore these issues.

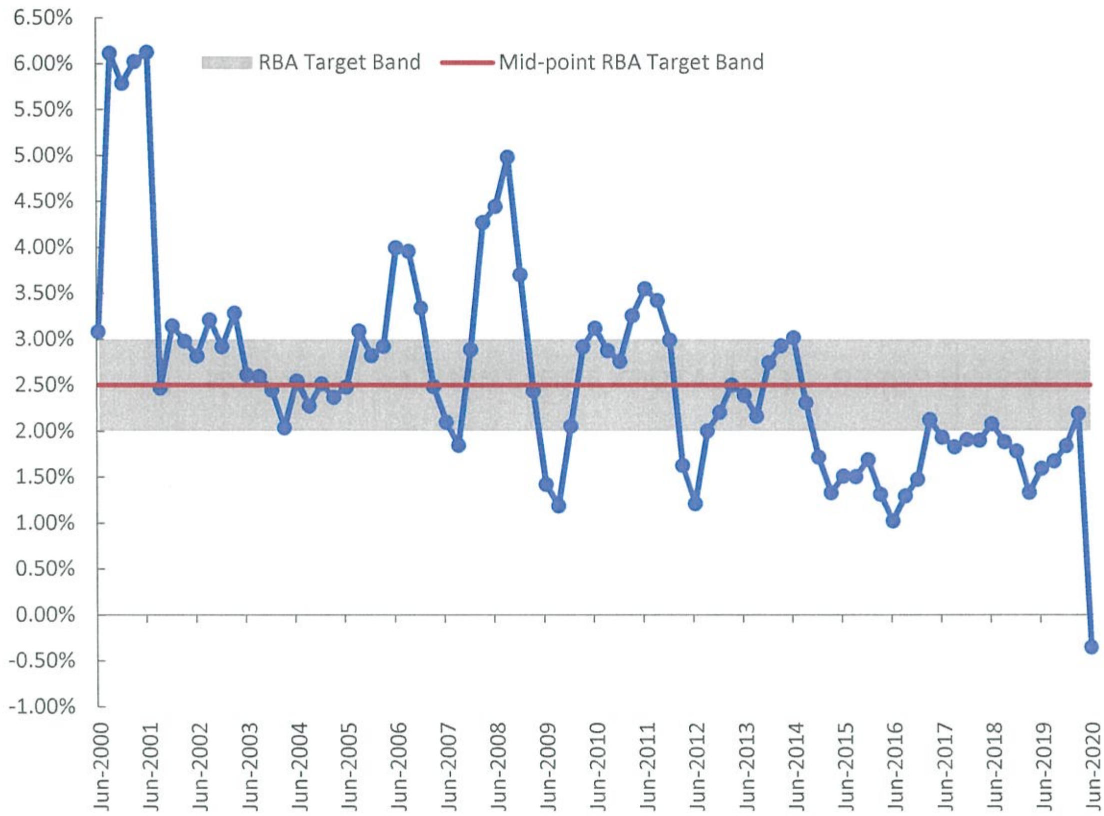
Energy Queensland Limited (Energy Queensland) appreciates the opportunity to comment on the AER's discussion paper and consultant reports. Energy Queensland is a member of Energy Networks Australia (ENA) and supports the comprehensive submission submitted by the ENA.

The treatment of inflation has been an issue of contention between the AER and network businesses for several years now. This has been driven by the AER's preferred method for estimating inflation increasingly producing unreasonable estimates in current economic conditions. The AER's method, which estimates expected inflation as a 10-year geometric average of the Reserve Bank of Australia (RBA) short term forecasts (for the first two regulatory years) and the mid-point of the RBA's target band (2.5 percent) for the following 8 years, unsurprisingly produces estimates of inflation that are heavily weighted towards 2.5 percent.

However, as the chart below shows, Australia has been in a protracted low inflation environment for close to a decade. For the last 24 consecutive quarters, actual inflation outcomes have been significantly below 2.5 percent—the mid-point of the RBA's inflation target band. Furthermore, in 20 out of the last 24 quarters, inflation outcomes have been below 2 percent—the lower bound of the RBA's target band.

It is also worth highlighting that the protracted low inflation environment is not just an Australian issue but a global phenomenon facing many advanced economies around the world. Energy Queensland believes that it is conceivable that as a result of the current global COVID-19 pandemic, with interest rate settings near zero, the low inflation experience could persist for a long time.

Figure 1 Annual change in CPI



In spite of this, the AER recently forecast expected inflation of 2.27 percent over the 2020-25 regulatory control period for Energex and Ergon Energy. The AER's forecast of expected inflation means that the AER forecast a negative real risk-free rate of -1.25% and the post-tax revenue models (PTRMs) for the networks forecast combined net losses of half-billion dollars. Energy Queensland queries how such outcomes promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity.

It is clear that amendments are required in relation to inflation. Inflation is a key parameter in the determination of regulated network revenues. It is in the long-term interests of consumers that network businesses are provided with a reasonable opportunity to recover their efficient costs and the treatment of inflation in the regulatory framework is key in this regard.

Energy Queensland appreciates that the AER is revisiting the inflation issues only 3 years after the last review, in 2017, where the AER opted against amending its approach. Notwithstanding this, we are extremely concerned with the AER's consultation process. We do not consider that it is appropriate that the AER commissioned expert reports prior to receiving submissions on its discussion paper. It is particularly disconcerting that the AER's experts seem to indicate that the current treatment of inflation and the AER's method for estimating expected inflation remains appropriate despite overwhelming evidence to the contrary.

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Should you wish to discuss any aspect of this matter further, please contact Guy Mutasa on 0429 832 367.

Yours sincerely

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