HAVYATT
ASSOCIATES

49 ANGEL ST
CORRIMAL NSW 2518
EMAIL: [redacted]
Web: www.havyatt.com.au
MOB: [redacted]

6 November 2020

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

By email: inflationreview2020@aer.gov.au

Regulatory Treatment of Inflation

Dear Mr Anderson,

I refer to the AER's *Draft Position: Regulatory treatment of inflation* of October 2020 (the Position), and the invitation to interested parties to make written submissions on it.

The AER is proposing a very significant change in the way it delivers its 'best estimate of expected inflation.' It remains important to be focussed on the objective here, because the AER's task is not to come up with the best forecast of inflation. As the Position shows the AER models are effective in delivering to regulated networks a real rate of return irrespective of the accuracy of the estimation as a forecast of future inflation.

The issue comes down to the fact that lenders to the businesses denominate their instruments in nominal terms, and so deviations between the AER estimate and lenders expectations result in the risk being borne by the equity investors. It is common to refer to regulated networks as 'risk free' because regulation guarantees a return. This is clearly not the case, as the discussion of inflation shows. And the AER includes the way the equity market prices this risk through application of the Capital Asset Pricing Model which in turn is based on realised returns.

While there are good reasons to reject the use of the CAPM because the AER is, in essence, merely measuring the cash flow impact of its previous decisions, its continued use by the AER reflects its belief that the CAPM accurately rewards the risk faced by investors.

What has been occurring over recent years is the crystallisation of one of these risks, just as the removal of Limited Merits Review crystallised an aspect of regulatory risk. In the case of the latter the AER made no adjustment to its approach to determining allowed revenues. In the case of inflation, the AER is making a change and, unless the Rate of Return is similarly adjusted, then the networks will get an increase in their returns relative to their risks.

The AER could quantify the impact by recomputing the outcomes for the equity investors in previous revenue determinations if the revised approach to estimating expected inflation had been used. This could be backward engineered to determine the reduction in the return on equity that would be required to match the reduction in risk faced by network businesses because of that decision.

Unfortunately, the AER has not provided this analysis. It has only provided analysis of the impact on the future value of the Regulatory Asset Base (RAB). More quantitative analysis should be provided by the AER. I acknowledge that all the data required to do this analysis is in the public domain, however, it is the AER that has the resources, expertise and obligation to provide it.

Since the AER commenced this project there have been significant changes in market conditions and policy settings that potentially warrant the change. The first is the Reserve Bank of Australia's own statements this month. RBA Governor Philip Lowe stated[1]:

> *Given the outlook for both employment and inflation, monetary and fiscal support will be required for some time. For its part, the Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, wages growth will have to be materially higher than it is currently. This will require significant gains in employment and a return to a tight labour market. Given the outlook, the Board is not expecting to increase the cash rate for at least three years.*

This statement is significant as the RBA has done what Energy Consumers Australia argued in an earlier submission it would do, and that is reset market expectations that the RBA won't be moving to constrain inflationary movements until inflation is substantially reignited.[2]

The second is captured in the RBA's observations on the causes of the low inflationary environment, which is poor wages growth.[3] While some of this can be attributed to pandemic induced wage freezes and employment trends. Unfortunately, this is being exacerbated by Government policy

---

[1] https://www.rba.gov.au/media-releases/2020/mr-20-28.html
[2] https://energyconsumersaustralia.com.au/publications/submission-to-aer-regulatory-treatment-of-inflation-discussion-paper
[3] https://www.rba.gov.au/publications/smp/2020/nov/inflation.html

decisions to restrict public sector wages.[4] It continues to be unfortunate in the extreme that Treasurers do not understand that their long war on public sector wages has been a significant contractionary force in the economy. More public sector workers on higher wages would, on balance, be far more stimulatory than tax cuts or incentives to business investment.

The risk for the AER is that the continuation of low growth, low inflation and low interest rates increases the likelihood of Government action to respond. The RBA's own interventions seeking to depress the value of the Australian dollar are just one example. This could easily result in the AER locking in a very low estimate of inflation immediately before a rapid reversal in inflationary trends. Indeed, the longer the low inflation environment continues the higher the likelihood of a rapid change brought about by different policy settings.

However, it appears that the prudent approach now may well be the change of approach developed by the AER, so long as the allowed rate of return is reduced commensurate with the reduction in risk faced by the network businesses.

I appreciate the opportunity to provide comment on the Position. Nothing in this letter is confidential. For the avoidance of doubt, while I am a former employee of Energy consumers Australia the opinions in this submission are entirely my own.

[redacted]

David Havyatt
Principal

[4] See for example the position in New South Wales. https://www.abc.net.au/news/2020-11-03/nsw-public-servants-will-not-get-their-2.5-per-cent-pay-rise/12842642