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Dear Sebastian

Inflation Forecast for JGN 2020-25 Access Arrangement

Jemena Gas Networks (**JGN**) is making this submission on the appropriate inflation forecast to be used for the JGN's 2020-25 Access Arrangement final decision (**final decision**).

We supported the AER's reason to delay our final decision in order

> *to allow the AER to use term forecasts of inflation from the Reserve Bank expected on 8 May 2020. This will allow the AER to include a more accurate reflection of the economic circumstances in our decision for the next regulatory control period.*[1]

In particular, our discussions with the AER were premised on improving the accuracy of the forecast revenues in light of the deteriorating economic conditions resulting from COVID-19 that were likely to lead to lower forecast inflation in the next two years.

This has not fully borne out in headline CPI forecasts from May 2020 Reserve Bank of Australia (**RBA**) Monetary Policy Statement (**MPS**).

We are writing formally to share our concern with now using unadjusted RBA inflation forecasts for the year ended June 2021. This is because in most circumstances there would be a very small difference between year ended December and year ended June forecasts. However, the single quarter transitory impact of the extraordinary (100%) short-term childcare subsidy by the Australian Government in response to COVID-19, mean that the differences are extreme in the current context and will result in a permanent under-compensation to JGN.

If left unchecked for the transitory policy effects designed to alleviate COVID-19 economic impacts by the Government, the forecast inflation in the final decision would be 2.42% using June 2021 and 2022 forecasts, which is in fact higher when compared with using February MPS.

We therefore propose that the AER applies forecast inflation of 2.15% in JGN's 2020-25 AA final decision based on December 2020 and 2021. Further, use of June forecasts will also be

[1] https://www.aer.gov.au/communication/aer-delays-final-decisions-for-sa-power-networks-energex-ergon-energy-directlink-and-jemena-gas-networks

internally inconsistent in regulatory modelling as JGN RAB and the price control mechanism used for annual revenue are both based on December inflation data.

This is consistent with AER's historical practice, and internally aligned with use of December inflation data for indexing JGN's RAB and actual revenue via the price control mechanism.

Background

Rule 75B(2)(b) requires the AER to specify in the Post-Tax Revenue Model (**PTRM**) a methodology that is likely to result in the best estimate of expected inflation. In the current **PTRM** models the AER states:

> *The AER uses an approach that calculates the geometric average based on the inflation forecasts for two years sourced from the latest available Reserve Bank of Australia's (RBA's) Statement of monetary policy and the mid-point of the RBA's target inflation band for eight years.*

For businesses with aligned regulatory years are financial years, the AER has historically used either the year ended December or the year ended June forecasts from the MPS. For example the AER used December forecasts for AusNet Transmission in April 2017 but it used June forecasts in the recent NSW electricity distribution decisions.

June 21 inflation forecasts is heavily distorted by Government childcare policy in response to COIVD-19

The May 2020 MPS provides the headline CPI forecasts that AER would typically use for estimating the forecast inflation in the PTRM (see table 6.1 of the RBA MPS).

It can be seen actual inflation for the December 2019 period was at 1.8%. In contrast the forecasts vary from a June 20 forecast of -1% (deflation resulting from COVID-19), followed by a forecast minor uptick in inflation by Dec 20 (0.25%). For 2021, there is a highly unusual spike in forecast inflation to 2.75% by June 2021, and then the forecasts trending lower 1.25-1.50% in the December 2021 and June 2022 period.

In light of this, JGN is concerned with the AER using what looks like an anomaly in the forecasts driven by COVID-19, namely a June 2021 inflation forecast of 2.75% for RY 21 as part of a 10 year inflation forecast.

If left unchecked, the forecast inflation in the final decision would be 2.42% using June 2021 and 2022 forecasts.

Table 6.1: Output Growth and Inflation Baseline Forecasts[(a),(b)]

Per cent

	Year-ended					
	Dec 2019	June 2020	Dec 2020	June 2021	Dec 2021	June 2022
GDP growth	2.2	−8	−6	7	6	5
(previous)	(2)	(2)	(2¾)	(3)	(3)	(3)
Unemployment rate[(c)]	5.2	10	9	8½	7½	6½
(previous)	(5.2)	(5¼)	(5)	(5)	(4¾)	(4¾)
CPI inflation	1.8	−1	¼	2¾	1¼	1½
(previous)	(1.8)	(1¾)	(1¾)	(1¾)	(2)	(2)
Trimmed mean inflation	1.6	1½	1¼	1¼	1¼	1½
(previous)	(1.6)	(1¾)	(1¾)	(1¾)	(2)	(2)

Source: RBA, Monetary Policy Statement, May 2020

We understand that the June 20201 inflation forecast in the May MPS is heavily distorted by the Government's decision to make childcare free in the June quarter of 2020 due to COVID-19 along with oil price movements. The Government policy is for childcare fees to be zero from 2 April 2020 to 28 June 2020 as follows.[2]

> *On 2 April 2020, the Australian Government announced the new Early Childhood Education and Care Relief Package. From Monday 6 April 2020 weekly payments will be made directly to early childhood education and care services in lieu of the Child Care Subsidy and the Additional Child Care Subsidy, to help them keep their doors open and employees in their jobs.*
>
> *Payments will be made until 28 June 2020 and families will not be charged fees during this time.*

Childcare accounts for 1.17% of the CPI basket as of April 2019.[3] Consequently, a temporary and extreme reduction in fees to zero in the June quarter 2020 has the effect of:

- reducing CPI by 1.17% in the June 2020 quarter; and
- increasing the CPI by 1.18% (=1.17%/(1-1.17%) in any subsequent quarter that is measured relative to the June 2020 quarter (including the year ended June 2021 forecast).

Consequently, the June 2021 headline CPI will be 1.18% higher than the June 2020 headline CPI due to childcare being free in the June 2020 quarter. This 1.18% accounts for 80% of the difference between the RBA's forecast of trimmed mean (underlying) CPI of 1.25% and headline CPI of 2.75% for the year ended June 2021.

On net basis, the childcare policy has little or no impact on actual or expected long-term inflation. The inflationary impact for the year ended June 2021 is offset by the deflationary impact for the year ended June 2020. However, if the AER uses the year ended June 2021 and June 2022 in its method, then the childcare policy will artificially raise the estimate of expected inflation, by around 1.18%, for the year ended June 2021. The use of June forecasts therefore becomes problematic due to this temporary childcare policy creating equal and

2 https://www.dese.gov.au/news/covid-19-early-childhood-education-and-care-relief-package-monday-6-april-additional-support

3 See row 88 of the "Table 1" sheet of "Consumer Price Index, Weighting Pattern, 2019"published by the ABS at https://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/6470.0.55.0022019?OpenDocument

offsetting deflationary and inflationary impacts but the AER's approach if applied using June forecasts would only pick up the inflationary impact.

Why the use of year ended June forecasts will result in under-compensation for JGN

JGN's RAB and actual revenue using the price control mechanism is based on December CPI data. The December CPI will capture both deflationary and inflationary impact of the childcare policy (for a net zero impact) because these values will include both the deflation in the June quarter and the inflation in the September quarter when the childcare policy is removed.

Typically there is not much difference between use of June or December forecasts. However, in the context of COVID-19 a single quarter impact of extreme (free) childcare subsidy has distorted year ended June forecasts. If June forecasts are used in the PTRM it will drive a significant and irreversible wedge between inflation forecasts using in the PTRM (which would include only the inflationary impact of the policy) and inflation indexing of the RAB (in the RFM based on December CPI) and actual revenues which will include both inflationary and deflationary impacts of the childcare policy.

Even if actual inflation turns out to be exactly as forecast by the RBA, JGN will have its:

- RAB and actual revenues indexed by 0.25% and 1.25% respectively based on December 2020 and December 2021 CPI (and every subsequent year ended December); but
- PTRM forecast revenues based on June CPI forecasts assumption that the RAB will grow at 2.75% and 1.5% for the years ended June 2021 and June 2022.

The net effect is permanent under-compensation for JGN. Even if the RBA forecasts are perfectly accurate, the business will never receive the 2.75% and 1.5% indexation (based on the year ended June 2021).

However, if this 2.75% is included in the PTRM forecast then the PTRM will implicitly reduce building block revenues based on the (incorrect) assumption that this will be offset by corresponding indexation of the RAB.

JGN is not asserting that the RBA forecasts are problematic but that if the AER uses the RBA year ended June forecasts, where affected on forecast inflation by transitory effects of Government childcare policy under COVID-19, then this will result in a serious inconsistency (qualitative and quantitative) between the inflation the AER is assuming JGN will be compensated for (in the form of higher RAB indexation) and the actual inflation JGN will be compensated for.

Available alternatives to the AER

The permanent under-compensation can be avoided if the AER utilises the year ended December forecasts which would have the net zero impact of the childcare policy. It will ensure the single quarter impacts of the Governments' childcare policy under COVID-19 do not play any net role in long term inflation forecasts (just as the policy does not play any net role in actual long-term inflation).

This is our preferred approach as it will be -

- consistent with AER's historical practice (in at least some of its decisions); and
- internally consistent with the use of December inflation data for indexing JGN's RAB and actual revenue via the price control mechanism.

Estimating expected inflation using the years ended December 2020 and 2021 will result in forecast inflation of 2.15%. This compares with forecast inflation of 2.42% using June 2021 and 2022 forecasts.

There are also other alternatives to remove the impact of childcare subsidy:

- Adopt a year ended June forecast but to remove the impact of the reversal of the childcare subsidy from the June 2021 forecast. This would result in the 2.75% forecast decreasing to 1.5% (rounded). The resulting 10 year inflation forecast under AER's approach would be 2.30%.
- Adopt the RBA's forecast of underlying (trimmed mean) inflation. This would result in a 10 year inflation forecast of:
  - 2.25% if year ended December is used;
  - 2.27% if year ended June is used.

Jemena's recommendation

We understand that the key reason for delaying the decision from April 2020 to May 2020 was to provide efficient level of revenues for JGN at a time when the RBA had relatively higher inflation forecasts in the February 2020 MPS and conditions in the financial markets were translating to unprecedented low return on equity allowance resulting from historically low risk free rate. RBA Governor Phillip Lowe in his speech on

- 19 March 2020 noted that -

"Financial market volatility has been very high. Equity prices have experienced large declines. Government bond yields have declined to historic lows. However, the functioning of major government bond markets has been impaired, which has disrupted other markets given their important role as a financial benchmark."

- 21 April 2020 noted that –

"In terms of inflation, we are also expecting a significant decline in the June quarter. The large fall in oil prices, combined with the introduction of free childcare and the deferral or reduction in some price increases mean that it is quite likely that year-ended headline inflation will turn negative in June. If so, this would be the first time since the early 1960s that the price level has fallen over a full year. In underlying terms, however, inflation is expected to remain positive."

It would therefore be at odds with the AER's stated purpose to use the June 2021 inflation forecasts for JGN, without properly considering the transitory but significant effect the COVID-19 related Government childcare payments are having on this forecast.

If left unaddressed and unadjusted in the PTRM, it would have the effect of imposing a permanent under-compensation to JGN in addition to negative equity return as explained in Attachment 7.2 of our Revised Proposal. JGN will also not benefit from the AER's forthcoming inflation review (where the AER may consider giving weight to market based forecasts that are currently, as at 8 May, below 1.1% at a 10 year horizon).

In light of this one in a 100-year event, we respectfully urge the AER to adopt a flexible approach, and within the bounds of the regulatory framework and the discretion available to the AER. We propose that the AER applies forecast inflation of 2.15% in JGN's 2020-25 AA final decision based on December 2020 and 2021 forecasts to ensure consistency with RAB and price control mechanism.

Please contact [redacted] if you would like to discuss this submission further.

Yours sincerely

[redacted]

Usman Saadat
General Manager Regulation

cc. Warwick Anderson, Slavko Jovanoski