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Luci Ellis
Assistant Governor – Economic
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001

By email: ellisl@rba.gov.au

Dear Dr Ellis

Regulatory treatment of inflation – inflation expectations

I am writing to seek your views in the context of an ongoing review of our treatment of expected inflation in our regulatory determinations. Under the National Electricity and Gas Rules (NER & NGR), the AER is required to determine the prices and revenues for monopoly electricity and gas network services. An important input into our price and revenue determinations is an estimate of 10 year expected inflation.[1] Recently, the method for estimating expected inflation has been the subject of debate. We are undertaking a review of the available information on estimating expected inflation and seeking stakeholder views to inform our decision.

Our current approach is to use a combination of the Reserve Bank's forecasts from the Statement of Monetary Policy and the midpoint of the Reserve Bank's target band. As part of the initial review process we have considered other methods, including the bond breakeven approach, the inflation swaps approach and publicly available surveys. The results are set out in a Discussion Paper and the ACCC/AER Working Paper #11 "Consideration of best estimates of expected inflation: comparing and ranking approaches".

1 We are primarily concerned about long-term inflation expectations. Our revenue models that we use to calculate regulated revenue are (currently) configured to provide a set real return to the regulated business. We determine an allowed rate of return required by investors over the life of the regulated assets. Regulated gas and electricity assets are typically very long-lived (about 40 to 80 years). Our current practice is to estimate a 10-year rate of return to proxy the required rate of return over the life of the assets – a 10-year rate being the longest rate that we can reliably estimate given constraints in obtaining reliable financial data. We then estimate expected inflation over a horizon commensurate with that of our rate of return.

When choosing a method we have had regard to its accuracy, robustness, transparency, replicability and simplicity. The RBA's opinion on the best method to estimate 10 year expected inflation rates when considering these features would be most welcome.

As part of our determination processes we received reports by service providers and their consultants on the best method to estimate expected inflation. These reports tend to favour using the bond breakeven approach. Of particular relevance is a report by CEG, "Best Estimate of Expected Inflation". Any comments you can provide on the relative merits of the bond breakeven approach or this report would be appreciated.

As mentioned above, we are currently reviewing our method of estimating expected inflation in light of submissions from stakeholders. We are seeking submissions on our Discussion Paper by 29 June 2017 and are actively engaging with interested stakeholders. We would greatly appreciate receiving your response by our submission closing date, 29 June 2017. We have attached CEG's report, our Discussion Paper, ACCC/AER Working Paper #11 and previous correspondence between AER and RBA. Any response that the RBA provides is likely to be referenced by the AER in regulatory decisions and made public.

If you have any queries, please contact Matthew Simpson at matthew.simpson@aer.gov.au on (03) 9290 1969.

Yours sincerely

W. J. Anderson

Warwick Anderson
General Manager
Network Finance and Reporting

Attached:

1. Previous correspondence between AER and RBA regarding the CGS market
2. AER Inflation Review Discussion Paper, April 2017
3. ACCC/AER Working Paper #11, Best Estimates of Expected Inflation: a comparative assessment of four methods, April 2017
4. Competition Economics Group, Best Estimate of Expected Inflation, September 2016