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

Dear Warwick

The MEU is quite concerned about the proposal from networks to change the approach used by the AER to set expected inflation in regulatory decisions. It appears to the Major Energy Users (MEU) that this proposal is about "cherry picking" a new element in the regulatory process to bias the outcome to favour networks. The MEU notes that, in this instance, this "cherry picking" approach has been effectively supported by the AER as the AER has only sought to address the very specific issue. The MEU is of the view that the AER should be addressing whether there should be a wider assessment of the issue including whether the various models used by the AER (such as the Post tax revenue model and the roll forward model) should be reviewed as well to identify if, rather than just examining the forecasts for inflation, there are wider aspects that need to be addressed

With this in mind the MEU makes two basic observations.

1. The MEU is aware that Energy Consumers Australia (ECA) has provided a detailed assessment of the issues and commissioned two consultant reports to provide a considered view of the issue. The MEU considers that the ECA has provided a sensible assessment of the specific issue of forecasting inflation and the MEU supports this response and the conclusions it reaches.
2. The models developed by the AER are predicated on trying to establish forecast revenue and prices that were only subject to CPI adjustment for each year of the regulatory period. This single adjustment was assumed to be what consumers wanted and, to achieve it, what was required was an accurate forecast of inflation. However, in recent years, annual revenues and prices vary significantly each year in addition to inflation adjustments because now the revenue for each year has to take account of a number of other adjustments that make a significant change to each year's allowed revenue. These adjustments include

    a. Debt cost changes because of the move to a trailing average approach
    b. Under/over recovery due to the revenue caps universally used
    c. Inflation

    Further, along with the changed revenue, the forecasts of expected usage (demand and consumption) made each year by the networks has a major impact on the prices charged for the services. So what consumers see now are annual price adjustments that bear little or no relation to price movements reflecting CPI.

    In addition to the forecast inflation, there are other aspects where there are forecasts made (such as forecast depreciation which gets rolled into the RAB, and forecasts of labour and materials price growth used to provide a forward looking estimate of costs the networks will incur). In accurate forecasts for these elements also increase risks for consumers and networks.

    With the large amount of adjustments now being made to each annual revenue allowance, the concept of having just a change in inflation apply as this is what consumers want just no longer has validity. With this in mind, the MEU considers that rather than trying to dream up forecasts for inflation and labour and material price growths, to meet the requirements of the Rules that prices be efficient and no more than needed by the networks, there should be a true up each year which eliminates any errors made in forecasts for inflation and labour and material costs.

Such a change would remove some of the risks that are faced by networks and so allow a lower return on equity to be paid by consumers. The outcome would also ensure that consumers pay no more than the efficient costs for the service.

We would be happy to expand further on this concept

We apologise for the late response to your discussion paper and hope that this does not create any inconvenience.

Regards

David

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