Submission

To: Australian Energy Regulator

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Topic: Regulatory Treatment of Inflation

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About Uniting Communities

Uniting Communities is a member of the national UnitingCare network, working with South Australian citizens across metropolitan, regional and remote South Australia through more than 90 community service programs.

Uniting Communities has provided financial counselling services for many years along with a range of low income household support services. It is through working with clients in these services that we have understood that extended periods of rapidly rising utility prices over the past decade are amongst the main reasons for people being pushed in financial stress. The unpredictability of utility bills and rapid increases have broken many lower income household budgets, despite the skill of low income people to manage their finances.

Process for Considering Regulatory Treatment of Inflation

Before commenting on the content associated with considering the regulatory treatment of inflation, Uniting Communities wishes to commend the Australian Energy Regulator on the approach being taken with this significant topic.

We recognise that there are a number of issues that are part of any network regulatory decision and that rather than deal with these issues in every single determination, it makes much more sense for a focused consideration of these common issues, across individual determinations. Inflation is a case in point - it is an issue that must be considered in any regulator determination and we think dealing with it in depth once, rather than recurring through individual determinations is a sensible and efficient approach. Once the guideline is established, it can be appropriately applied to a number of individual company revenue decisions.

Of course it is crucial that all key stakeholders, including consumer interests, are actively involved with such processes, and we are satisfied that this has been the case so far, for this inflation focussed process. We are aware that occasionally the view is expressed that consumers are not well placed to deal with the more complex or technical aspects of energy regulation. We strongly reject this notion and have previously identified processes that enable consumers, even those without prior knowledge, to contribute very helpfully to debates around the more technical and complex energy industry issues. The 2015 report produced by UnitingCare Australia (DNA approach to network regulation[1]) discusses deliberative and negotiation techniques that enable informed consumer input.

We recognise that this process so far has involved consumer interest advocates with leadership from Energy Consumers Australia who have commissioned a couple of expert reports to assist in considering the key aspects of inflation in regulatory context.

We also note that the UK regulator Ofgem, considers all similar network business revenue proposals at the same time. So there are three separate processes dealing with all electricity distribution businesses in the UK simultaneously, all gas and then all electricity transmission businesses subsequently, as groupings of similar businesses. This means that a topic like inflation, in the UK, is considered across all electricity distribution network businesses at the same time. We suggest that this provides a reasonable regulatory precedent for the AER consideration of a single inflation guideline to be applied across all regulated network businesses over an agreed period of time.

[1] http://noshockenergy.org.192-81-211-8.ericdekock.com.au/wp-content/uploads/2016/07/DNA-of-network-tariff-setting-June-2015.pdf

We also highlight that inflation guideline should be binding one, to apply over a specified period of time, e.g. 3 to 5 years. A binding guideline, once a thorough development process has occurred involving all relevant stakeholders, is efficient and provides greater certainty to all parties, including end consumers and hence is more in line with the national energy objective than the company by company approach that has been applied over recent years.

Regulatory Treatment of Inflation - context

We make four brief observations about the context of inflation in the Australian energy regulatory processes:

1. Treatment of inflation is integrated throughout many aspects of Australia's energy regulatory approach with the overall approach being for network revenue outcomes for each new regulatory period to be based on:

   CPI – X where, we assert the reasonable customer expectation is that X>0

   The consumer price index, CPI is the most common measure of inflation used in Australia. The Australian energy regulatory approach is based on the expectation for end customers that CPI is the maximum price increase the can be expected. This of course has not been the reality for end customers across Australia for many years. Every day Uniting Communities services are seeing people whose quality of life is reduced by energy price increases that are multiples of CPI. We are currently bracing ourselves for yet another increase in financial hardship and further demands on our services as customer energy bills increase by about 20% from 1st July 2017, while CPI is 2.1%[2]

   The reality remains that the nominal inflation rate should be the upper bound for energy price increases.

2. We also recognise that inflation is central to a number of aspects of the base – step - trend approach to determining revenue allowances for energy network businesses. Inflation rates influence return on debt, return on equity, depreciation schedules, future revenue forecasts the value of the Regulated Asset Base and other key parameters, so the importance of 'getting inflation right' is evident.
3. Inflation is also an important measure of fairness, specifically intergenerational fairness. Many energy industry assets are long term investments, meaning that all customers for the life of the investment should be paying for their share of the use of that investment. no more and no less. If current inflation levels are set too low, then there is a good chance that future customers will pay more than their fair share effectively cross subsidising current customers, assuming that the net impact of a too low CPI is for inadequate short term return to capital. We believe that the long-term interests of consumers means all consumers are treated fairly over time, with no one group paying any more or less than is necessary, at any point of time.
4. We also note our understanding that this process is a supply-side only consideration of the treatment of inflation. We suggest that a demand-side approach would require a different methodology as the incidence of inflationary measures is much more variable across the breadth of the consumer base than the relatively similar contexts across the supply-side of energy markets. (For example, the basket of goods and weighting applied in determining the CPI is an excellent average measure but it is not an accurate approach for changes in cost of

[2] All groups CPI, seasonally adjusted, 12 months to 31/3/2017, ABS 6401.0 - Consumer Price Index, Australia

living over time for different household types. Currently lower income households are subject to price rises that are generally higher than CPI / the inflation rate because the elements of the basket of goods that they consume are those with higher rates of increase, including housing, health and energy costs. They under consumer goods and services whose costs are changing at less than CPI, for example electronic goods, recreational activities and holidays.

Regulatory Treatment of Inflation – context

Uniting Communities strongly supports the submission made to this review by Energy Consumers Australia, a submission that included input from two sources of expertise namely: Woollahra Partners and Professor Quiggin. There is no purpose in our repeating the arguments in representing their submission. However we wish to emphasise the key conclusions of their submission, firstly:

"The proposal to base estimates of inflation on market indicators is inappropriate in this context as it introduces unnecessary regulatory risk. The appropriate estimate is to use the RBA target band to provide a consistent measure. Investors make their investment choices on the basis of nominal rates, not an implied real rate. Setting estimated inflation at the top of the RBA band appropriately allocates inflation risk to investors."

In summary we agree that the RBA inflation target method is more likely to provide best estimates of expected inflation than swap-implied estimates or bond breakeven estimates The RBA data is robust, readily available, directly relevant to Australia and importantly is widely understood by consumers.

We also highlight the final paragraph from the report prepared by Professor Quiggin for ECA:

"Given that the regulatory system provides asset owners with a guaranteed rate of return, while providing no guarantees to consumers of stable real prices, it is important that consumers should not be exposed, in addition, to upside inflation risk. This can be prevented by setting the regulatory rate of inflation at the upper end of the RBA target range."

We reiterate the perspective that "the regulatory rate for inflation should be set at the upper end of the RBA target range"

Final note

We have already noted that the inflation guideline should be binding for periods specified. This includes holding firm to the guideline during periods of very high volatility, for example global financial crisis which we continue to assert triggered price increases for customers that were burdensome and sustained for much longer periods than were necessary. Widespread stakeholder engagement must ensure that the robustness of the inflation guideline is such that it can deal with extreme finance market or monetary policy (which highly unlikely) shocks, particularly shocks that are passed on to customers and with much greater impact than is warranted.