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Mr Warwick Anderson
General Manager, Networks Finance and Reporting
Australian Energy Regulator
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By e-mail: InflationReview2020@aer.gov.au

Regulatory Treatment of Inflation Discussion Paper

Dear Mr Anderson,

Energy Consumers Australia appreciates the opportunity to comment on the Australian Energy Regulator's (AER) *Regulatory Treatment of Inflation Discussion Paper* (the Paper). As with all aspects of the economic regulation of networks, the treatment of inflation has significant impact on the prices paid by consumers for network services and hence on the achievement of the national energy objectives.[1]

Energy Consumers Australia is the national voice for residential and small business energy consumers. Established by the then Council of Australian Governments (COAG) Energy Council in 2015, our objective is to promote the long-term interests of energy consumers with respect to price, quality, reliability, safety and security of supply.

Our research on consumer preferences and expectations through the Energy Consumer Sentiment Survey (ECSS)[2] and the Consumer Expectations Research[3] reveals that consumers' highest priority remains affordability and the area of least satisfaction is current value for money. At the same time consumers expectation is that energy services are simple and easy to manage.

Based on this research, we have developed the 'Affordable, Individualised, Optimised' or 'AIO' framework to describe the way these elements around value, technology and trust are interacting in the new energy system. In simple terms what the concept says is that in the new market affordability is a function of individualised services within an optimised system. The A-I-O framework creates twin goals of delivering energy services at least cost and putting the consumer in control.

We approach the review of expected inflation (the Review) through this lens. While the treatment of inflation has significant impact in the functioning of the mechanics of economic regulation, fundamentally the 'building block model'[4], our consideration is based on the wider context of consumer expectations on the future of networks, especially electricity distribution networks.

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[1] Meaning the National Electricity Objective (NEO) and the National Gas Objective (NGO).
[2] https://energyconsumersaustralia.com.au/projects/consumer-sentiment-survey
[3] https://energyconsumersaustralia.com.au/wp-content/uploads/Future-Energy-Vision-Forethought-Household-Full-Report.pdf and https://energyconsumersaustralia.com.au/wp-content/uploads/Future-Energy-Vision-Forethought-SME-Report.pdf
[4] https://www.aer.gov.au/system/files/AER%20information%20session%20one%20-%20Overview%20of%20building%20block%20framework%20-%2030%20November%202017.pdf

Three key issues

In the Paper the AER states that it will initially examine three key issues:

- What method should we use to estimate expected inflation?
- Does the regulatory framework successfully deliver the expected real rate of return under the current approach?
- Should we instead target a nominal or hybrid return?

In this submission we propose that the AER should not change the method used to estimate expected inflation, that the framework (i.e. the Post Tax Revenue Model (PTRM) and the Roll Forward Model (RFM)) delivers the expected real return, and that no case has yet been made on changing the overall regulatory approach from targeting a real return to targeting a nominal or hybrid return.

The Paper addresses these issues by posing seven specific questions. We will respond to these after a brief discussion of the essential underlying principles.

The first principle is that the AER's task under the existing rules is not to forecast inflation, but to derive a 'best estimate of expected inflation.'[5] The question then emerges that since expected inflation is subjective, whose expectation is being measured. The 2017 review was triggered by network businesses identifying what they claimed was a disconnection between expected inflation as measured by market measures and the approach of the AER. The AER was not persuaded by the networks' arguments.

The issue raised in the 2020 review is different to that raised in 2017. It is based on a separate claim that the AER's methodology has been systematically biased to result in actual inflation being lower than the AER's estimate of expected inflation.

Returning to the first issue, investors in and lenders to networks are aware that revenue is totally determined by the regulator. Networks do have some cashflow exposure determined by their own efforts to achieve rewards under various incentive schemes. Analysis by Energy Networks Australia (ENA) reveals that these incentive schemes have been producing significant net benefits to networks (and eventually consumers in theory)[6]. As identified by Professor Johnstone in the expert sessions for the 2018 Rate of Return instrument, the weakness of the Capital Asset Pricing Model (CAPM) is that in estimating *beta* the AER is only measuring how the market valued previous regulatory decisions.[7]

In such a world our view is that a rational investor or lender would develop their expectation of inflation by reference to the method the AER uses to determine expected inflation in their model.

If we accept that the expectation of the investors and lenders should be informed by the AER estimation, the question emerges of what could 'best' in the National Electricity Rules (NER) refer to? As with everything else in the regime the standard should be how the approach promotes the long-term interest of consumers. On this basis, the expert report from Professor Quiggin attached to our first submission on the last review proposed that the AER should choose 3% being the top of the

[5] See NER 6.4.2(b)(1).
[6] ENA 2019, *Rewarding Performance: How customers benefit from incentive-based regulation* Energy Networks Australia. https://www.energynetworks.com.au/resources/reports/rewarding-performance-how-customers-benefit-from-incentive-based-regulation/
[7] https://www.aer.gov.au/system/files/AER-%20Concurrent%20Evidence%20Session%201-%20Proofed%20Transcript.pdf

Reserve Bank of Australia (RBA) target range.[8] He argued that consumers have limited ability to manage inflation risk, while networks do, and that on the principle that risk should be allocated to the party best able to manage it, that should be the networks.[9]

The second issue that has motivated the 2020 review is that the RBA has consistently failed to achieve inflation in the target range for an extended period. However, the argument assumes that this situation must continue, when the reverse is likely to be the case.

The RBA and others involved in economic policy have realised that monetary policy is a very effective tool for reducing inflation, but that it is a very poor tool for stimulation. The extended period of inflation being below the target band provides reason to believe that other policy mechanisms will be utilised to increase inflation. Contrary to the arguments of the networks, the long period of not reaching the target means the target is more likely to be met or exceeded in the near future, given the need for economic stimulus because of the downturn in the economy.

For these reasons ECA continues to take the view that the prudent option is that the estimate of expected inflation should be set at the top of the RBA target range.

Response to questions

Q1 What are the available indicators of expected inflation and what are their strengths and weaknesses?

> Generically there are three available indicators of expected inflation, being the indicators provided by monetary policy, by markets in expected inflation, and by asking people their expectations. The first of these indicators is provided by the RBA that through its actions can change the course of inflation, and is therefore the only indicator that should be considered. The other two approaches are simply expectations of the future possible outcomes of policy action.

Q2 Should we continue to use our current approach to estimating expected inflation?

> Yes. In the Paper the AER identifies five possible mechanisms for estimating expected inflation, being no change, a glidepath, breakeven rates, swaps or surveys. To this we add the approach proposed by Professor Quiggin of choosing the top of the range.
>
> There are powerful reasons for not changing the approach to estimating expected inflation. The first of these is that investors and lenders should already have formed their expectations of the regulatory treatment of inflation from the AER's existing approach.
>
> The second is that any change to the approach to expected inflation will have implications for the rest of the regulatory approach.

Q3 Are there improvements we could make to our current approach to estimating expected inflation?

> No, other than to consider Professor Quiggin's recommendations.

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8 https://www.aer.gov.au/system/files/ECA%20submission%20on%20regulatory%20treatment%20of%20inflation%20-%203%20July%202017.PDF

9 Note the important concept is the ability to manage the risk, not to simply bear the risk.

Q4 Should we use an alternative approach to estimating expected inflation? If so, set out the alternative approach and its advantages over our current approach?

As for Q3.

Q5 Does our current approach deliver the target ex-ante expected real rate of return?

Yes. Also as demonstrated by Woollahra Partners report attached to our first submission to the last review the impact of differences between expected and actual inflation is small and symmetrical. As there is no consistent bias, over time the network will not suffer economic loss if the variation between expected and annual is uniform.

As argued above a single instance of a period of successive differences does not provide evidence that over multiple regulatory periods that actual inflation will be consistently under or over expected inflation.

Q6 Should we switch to a nominal or hybrid approach to setting NSP revenues?

In our view the case for change has not been made sufficiently.

We note that we have no research on consumer preferences for the price path of energy prices. However, the price path is also heavily influenced by the existing approach to depreciation (which while leveling the real amount of depreciation of an asset in each year still results in higher payments for an asset in the first year) and setting the X factor (which is typically chosen to provide maximum benefit to consumers in the first year of a regulatory control period).

We further note that research on consumer preferences should be conducted by the party that is proposing a change in the current arrangements, which is in this case the networks. If the networks propose to undertake such research, we recommend that they do so in consultation with the Consumer Reference Group.

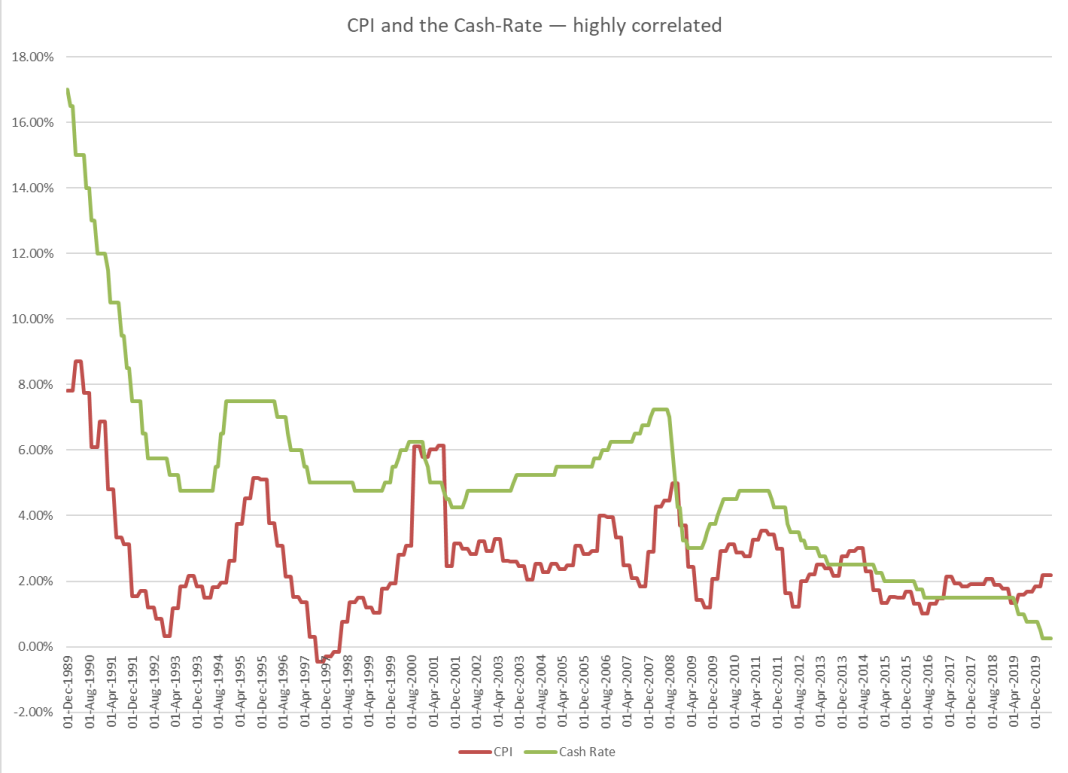
There are many reasons why any change in the approach within the existing building block model is not desirable. The first and most significant is that the investor and lender expectations are based on the existing model.

The networks have presented modelling that demonstrates that it is the equity investors who bear all the consequences of a difference between expected and actual inflation. In the presentation the networks state “Networks are not proposing anything that shifts any risk from networks to consumers.”[10] We find this claim from the networks hard to follow, because the consequence of this proposal is to reduce the variability of the return on equity as a consequence of inflation outcomes. Clearly a reduction in the variability of an outcome is the very definition of risk. Consequently, any change in the approach away from targeting real returns would require a review of the return on equity and some estimate made of how the market would value this reduction in risk.

We are further concerned that the other issue of concern to networks, the very low risk-free rate, is correlated with the issue of inflation outcomes. Unsurprisingly, given that the goal of monetary policy is inflation targeting the risk-free rate and inflation are closely correlated, as shown in Figure 1 below.

[10] https://www.aer.gov.au/system/files/Energy%20Networks%20Australia%20-%20Inflation%20review%20public%20forum%20presentation%20-%202%20July%202020.pdf

Figure 1: Year on Year CPI and the RBA target cash rate



We note however the most recent period in which the correlation is reversed.

Energy Consumers Australia considers that the issue of 'risk-free rate roulette' has become significant and that a trailing average approach to the cost of equity should be considered and modeled by the AER.

Q7 What is the best approach to incorporate inflation expectations into the trailing average return on debt? Explain why you consider your approach is the best approach.

The trailing average assumes the network has raised one tenth of its debt in each of the preceding ten years. The nominal return on debt for each year needs to be adjusted by the expected inflation for that year (just as the return on debt is based on the risk-free rate of that year).

If you have any questions regarding this submission please contact our Senior Economist, David Havyatt at david.havyatt@energyconsumersaustralia.com.au or on 0414 467 271.

Yours sincerely,

Lynne Gallagher
Chief Executive Officer (Interim)