

**AER inflation review
Interactive workshop summary**

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| Matter name: | Interactive workshop – AER Review of the regulatory treatment of inflation — post release of the preliminary position paper |
| Date: | 31 October 2017 |
| Time: | 9.00 am to 1.00 pm |
| Location:  | Stamford Plaza Sydney Airport |
| Chair | Jim Cox, Board Member, AER |
| Phone to [ ]   | Phone from [ ]   | Meeting [x]  | Other [ ]   |

*Note: This document provides an overview of the main points discussed during the AER’s preliminary position interactive workshop. The AER will consider and review points raised by stakeholders at the interactive workshop when constructing its final position.*

**Background**

The Australian Energy Regulator (AER) held an interactive workshop as part of its industry-wide consultation and review of the regulatory treatment of inflation. The objective of the workshop was to allow stakeholders to discuss—with the AER, but also with each other—the key issues set out in the AER’s *Preliminary position paper*. This opportunity allowed stakeholders to respond to the reasoning set out in that paper, as well as to provide fresh insights and material prior to finalising our position.

**Format**

The workshop was set up as two panel discussions. We structured the day to reflect the diversity of views on several key issues. Based on earlier submissions to our review, we identified key proponents for each perspective and invited them to sit on discussion panels. These panel discussions occupied the bulk of time at the workshop. Dialogue between panel members, and also with those asking questions and making comments from the floor, allowed the workshop to explore the reasoning behind contrasting views on several key issues.

The agenda for the day set out the key issues to be covered by the two panel discussions.

* The first panel discussion focussed on what we referred to as ‘Issue 1’—the method used to estimate expected inflation.
* The second panel discussion focussed on ‘Issue 2’—the appropriate inflation compensation in the regulatory models (including the post-tax revenue model, roll forward model and annual pricing process).

The workshop began with a welcome by the chair and a brief summary of the AER preliminary position.

**Panel I discussion summary**

Panel I discussion was split into two sections: the strengths and weaknesses of alternative inflation estimation methods and the potential use of a glide path. A diverse range of views were initially presented by the panellists:

* Stephen Gray (Frontier, consultant for ENA) stated he was seeking an outcome that is appropriate for the long-run. Suggested that a move to such an outcome would be ideal in the current environment (no significant movement). Concerned AER was choosing just one estimate and not considering a weighted combination. Ideally weights adjusted depending on conditions at the time.
* Bev Hughson (CCP) stated that the best estimate should be chosen on a principled basis. Believed the AER is currently doing this. There should be a high barrier to change due to the importance of regulatory stability and once a method is chosen it should be consistently applied.
* Hayden Mathysen (ACCC, consultant for AER) discussed the findings of the ACCC/AER Working Paper on inflation. These included the five criterion applied, that the RBA’s forecasts are relatively accurate based on public information and that research showed the bond breakeven approach is contentious particularly with the term structure estimates and decomposition methods applied.
* Sandeep Kumar (Jemena) stated that it’s hard to justify an inflation reversion from 1 per cent back to 2.5 per cent immediately. A glide path is a possible solution to this. Further analysis on mean reversion should be completed as well as considering international implementation of glide paths.
* David Havyatt (ECA) stated that best estimate should take into consideration the overall regulatory construct. A combination of RBA forecasts and 3 per cent for years three to ten would satisfy the best estimate. This would provide protection for consumers from the risk that inflation is above the inflation estimate. Stated that the framing of expectations by the RBA has consequences in markets.

Below is a brief summary of some of the discussion after the initial presentations.

*Best estimate*

Discussion around the best estimate fell into 2 broad groups:

* A view that all four considered methods had value. The value of each method could vary over time. Therefore all methods should be considered relevant evidence and weighted according to prevailing market conditions.
* A view that the very nature of the use of the words best estimate required the AER to pick one estimate and that a weighting of different methods does not give proper consideration to each method’s value and will open up unnecessary debate around the weights.

Discussion was also had on the difficulty in quantifying biases and therefore appropriate weights, as well as apparent weight of zero the AER is applying to the bond breakeven method.

*Issues with the preliminary position’s analysis*

Some industry stakeholders identified shortcomings of the AER’s Preliminary Position Paper (PPP). In particular:

* That the PPP (i) did not engage with submissions, (ii)assertion/conclusions were not supported by evidence, (iii) conclusions weren’t explained, (iv) rejection of approaches based on potential issues rather than identified and material issues, and (v) reversion considered in the context of actual inflation reverting rather than expected inflation.
* Consumer stakeholders did not agree with these views. A consumer stakeholder raised the point that the AER must make a holistic view of the evidence and make a decision internally consistent rather than looking at each piece of evidence in isolation.

*Can we improve the AER’s current approach using a glide path?*

Stakeholders generally had one of these three points of view:

* There is no empirical evidence at this stage to suggest the need for a change.
* Unlikely that inflation will reach 2.5 per cent in the third year if the second year forecast is below 2 per cent (or in the case of some extreme event). A glide path should be considered but no preferred method at this stage.
* If consideration is made for a glide path for potential extreme events, then a mechanistic approach would be most appropriate to be implemented.

*The bar for change*

Some consumer stakeholders put forward that there needs to be a relatively high bar for changing the regulatory regime. Regulatory stability is important to consumers and investors.

**Panel 2 discussion summary**

The agenda split the Panel 2 discussion into two sub-issues, although the discussion on the day was not explicitly segmented:

* The overall inflation treatment in the regulatory models (PTRM/RFM and annual pricing), including the appropriate inflation target
* Inflation exposure for equity holders when debt is fixed in nominal terms.

Jim Cox commenced the session by asking all panel members to comment on deviations around the delivery of the current inflation target, which is the initial real rate of return. A follow-up question asked them to explain how their preferred approach would serve the long term interest of consumers:

* Tom Hird (CEG, for Spark) stated that the target should not be the real rate of return on capital (debt and equity), but instead the real return on equity when paying fixed nominal debt costs. It was in the best interests of consumers to recognise the efficient financing costs of the benchmark entity, and that meant issuing nominal debt. The current AER approach imposed regulatory risk as a result.
* Eric Groom (CCP) stated that the real return on capital was the correct target, and that this is delivered by the current regulatory models (with minor variation). Targeting the real rate of return was in the long term interest of consumers because it was a stable regulatory approach, was widely practiced in Australia and overseas, had provided reasonable returns over a long period of time, and allocated financing risk to the party best placed to manage that risk.
* Scott Young (APA) stated that the relevant question was to ask how the forecast of inflation (which will always be wrong) can be prevented from impacting revenue outcomes. It does not matter what the target is (nominal or real), but it needs to be delivered correctly. The business currently wears the risk arising when depreciation in the PTRM and RFM differ, and APA’s proposed inflation changes were designed to eliminate this inconsistency.
* Tony van Zijl (Sapere, consultants to AER) stated that the models achieved the intended target, but noted the extent of deviation because of first year pricing, errors in estimation, and debt costs fixed in nominal terms. Delivery of the *ex ante* real return was consistent with efficient investment and the long term interests of consumers.

Questions from the floor led to discussion of the following issues:

* The impact of using a trailing average portfolio cost of debt instead of an on-the-day assessment. Some stakeholders considered that this introduced a material inconsistency; other stakeholders considered that the net impact of these changes favoured the service provider even in the presence of inflation risk.
* The degree of prescription in the AER’s definition of the benchmark entity. Some stakeholders considered that the AER needed to define a benchmark debt issuance strategy (where fixed nominal debt is issued each year, or an alternative approach); other stakeholders considered that this level of prescription was not necessary.
* The assignment of inflation risk between consumers and service providers; and between equity holders and debt holders. Some stakeholders stated that if consumer incomes moved in line with inflation it was appropriate for them to bear inflation risk; others considered that businesses but not consumers had the means to manage this risk; other stakeholders considered that changes to the inflation approach could entirely remove risk from all parties.
* The degree to which inflation risk (generally; or specifically arising from debt-equity interactions) was already included in the allowed rate of return. Some stakeholders considered that inflation treatment would impact on systematic risk exposure (and the equity beta); other stakeholders considered it would not.