AER: Inflation review 2020
Our draft position

Stakeholder Forum

21 October 2020

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aer.gov.au

Agenda

Agenda item	Presenter	Time allotted
Participant connection		10.00 – 10.05am
Welcome/Introduction	Warwick Anderson	10.05 – 10.15am
AER presentation	Eric Groom PSM	10.15 – 10.35am
CRG presentation	Dr Ron Ben-David	10.35 – 10.55am
ENA/APGA presentation	Patrick Makinson (ENA) and Nick Wills-Johnson (APGA)	10.55 – 11.25am
Closing	Warwick Anderson	11.25 – 11.30am

Email all questions to InflationReview2020@aer.gov.au

Scope of the review

It is our role to ***determine a method that is likely to result in the best estimates of expected inflation.***

We have therefore considered:

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

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Method to estimate expected inflation

- **Current approach:** 10 year term averaging RBA forecasts of inflation for years 1 and 2, then RBA mid-point (2.5%) for years 3 to 10.
- **Proposed approach:**
  1. **Shorten the target inflation term** to a term that matches the length of a regulatory period (typically five years); and
  2. **Apply a linear glide-path** from the RBA's forecasts of inflation for years 1 and 2 to the mid-point of the inflation target band (2.5 per cent) in year 5.

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Change inflation term to match regulatory period

- Shorter inflation term:
  - matching the length of a regulatory period better matches our treatment escalating the RAB.
  - matching the regulatory period is more responsive to changes in market conditions.
- Do we need a transition?
  - We have not formed a view on whether or not a transition period to the new inflation term is in consumer interests.

Glide-path to year 5

- For a typical five year regulatory period, adopting a linear glide-path, and based on the RBA's current practice of forecasting inflation for two years, our estimate of inflation would be:
  - Year 1: RBA forecast
  - Year 2: RBA forecast
  - Year 3: Glide value
  - Year 4: Glide value
  - Year 5: 2.5 per cent.

Applying a shorter term and glide-path

Issue/concern	Mitigation
That our ten year rate of return may be upwardly biased in a period of extended low inflation outcomes.	A term that matches the length of the regulatory period will largely address this concern by being more responsive to short-term inflation estimates than long-term estimates. Additionally, a glide-path acknowledges that it may take longer than three years for expected inflation to revert to the mid-point of the RBA's target band.
The inconsistent use of inflation across the PTRM and RFM over the regulatory period because of the use of a ten year estimate of expected inflation.	Using an estimate of expected inflation that is based on a term that matches the length of the regulatory period in the PTRM will ex-ante match expected RAB indexation over the regulatory period. This ensures that ex-ante the expected nominal return (and real return) will be delivered over the regulatory period.
Expected inflation will not revert back to 2.5 per cent by year 3 based on current market data.	The use of a glide-path approach accounts for inflation taking longer than two years to revert to the RBA's target band.
RBA forecasts are unreliable. Therefore, market-based measures should be adopted.	RBA forecasts remain best available. Market-based measures are subject to biases and distortions that make them unsuitable.

Stakeholder impacts: Scenario

Method	Estimate of expected inflation
Current method (10 years)	2.30%
Current method + glide-path	2.22%
5 year + glide-path	1.95%
5 years (no glide)	2.10%

Adopting 1.95 per cent for our draft Victorian distribution determinations would result in approximately:

- an extra $300 million ($real 2021) in allowed revenue (across all Victorian distributors) over the next five years (out of total revenue of $10 billion approx. Equivalent to 3% higher revenue.
- around $8 more per annum on a (Victorian) customer's bill than using the current method—holding all else constant.

Transition

- Still considering whether a transition (deferred or phased in change) is required.
- **Transition:**
  - Avoids ex-ante gains/losses from immediate change.
  - Allows term of RoRI to be considered simultaneously
- **No transition:**
  - Avoids delay in matching estimate with reg period/RAB indexation.
  - Removes ex-ante RoR mismatch over upcoming periods.
  - Reduces likelihood of NSPs receiving negative cash returns in period of low inflation.

Real return regulatory framework

- The net effect of the framework set by NER/NGR:
  - Service providers are compensated for movement in inflation because we index the RAB for actual inflation.
  - Service providers receive the ex-ante real return on assets set in our regulatory determinations.
  - Service providers may receive (ex-post) a nominal return above or below the ex-ante nominal return set in the binding rate of return instrument, depending on inflation outcomes.
- Many precedents for this approach:
  - Change in estimation of inflation expectations substantially addresses concerns.

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Hybrid/nominal framework?

- We are not persuaded that either the hybrid or nominal option is preferable to our draft position based on the evidence available to us.
- We have noted that a change in framework to a hybrid approach could:
  - change the relationship between CPI, cash flows and financial incentives for investors and service providers.
  - change the risk profile for each stakeholder.
  - impact regulatory certainty from the current framework.
- Currently, insufficient material on the impact on consumers of a hybrid and why it is in their long-term interests for us to initiate a change.

Questions

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Next steps: indicative timeline

Date	Milestone
6 November 2020	Submissions on draft position paper close
December 2020	Final position paper
January 2021	(If required) Proposed PTRM/RFM amendments and explanatory statement released (If required) Six week submission period on proposed model amendments (If required) Proposed rule change process
April 2021	(If required) Final PTRM/RFM amendments released