Public forum Q&A

Regulatory treatment of inflation – draft position

October 2020

AUSTRALIAN ENERGY REGULATOR

Inquiries about this publication should be addressed to:

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AER reference: 65487

Invitation for submissions

The Australian Energy Regulator invites interested parties to make written submissions on our draft position on the regulatory treatment of inflation by close of business, **6 November 2020**.

We prefer that all submissions sent in an electronic format are in Microsoft Word or other text readable document form. Submissions should be sent electronically to InflationReview2020@aer.gov.au.

Alternatively, submissions can be sent to:

Mr Warwick Anderson
General Manager, Networks Finance and Reporting
Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

We prefer that all submissions be publicly available to facilitate an informed and transparent consultative process. Submissions will be treated as public documents unless otherwise requested. Parties wishing to submit confidential information are requested to:

- Clearly identify the information that is the subject of the confidentiality claim.
- Provide a non-confidential version of the submission in a form suitable for publication.

We will place all non-confidential submissions on our website. For further information regarding our use and disclosure of information provided to us, see the ACCC/AER Information Policy (June 2014), which is available on our website.

Please direct enquiries about this paper, or about lodging submissions to InflationReview2020@aer.gov.au or to the Networks Finance and Reporting Branch of the AER on 1300 585 165.

Public forum Q&A

We commenced a review of the regulatory treatment of inflation (inflation review 2020). In May we published a discussion paper outlining the issues under review. On 1 October 2020, we published our draft position on the regulatory treatment of inflation.

Interested stakeholders were invited to our second public forum to discuss the issues/matters raised in our discussion paper. The forum was held on 21 October 2020. Due to COVID-19, the forum was conducted via Webex and consisted of a set series of presentations. These presentations, together with the forum agenda are available at www.aer.gov.au.

We also invited participants to email us questions throughout the forum to be addressed after the forum. These questions may be directed to us, or any one of the stakeholders presenting. This document compiles the responses to the questions posed. These responses are provided in a short timeframe without full analysis.

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Questions and responses

Received from	Question	Response
Jemena	**Question for AER**: Is the AER is amendable to moving to December to December series in the PTRM to align with the RFM RAB and capex indexation instead of using a June to June series. This will help cover the timing mismatch and make it more robust estimate.	We do not consider that it is appropriate to use year-to-December CPI where the regulatory period starts in July because: • The expected inflation estimate should align with the regulatory control period. In particular, the estimate of expected inflation should not include historical inflation, as it does not fall in the forthcoming regulatory period. Likewise, not including the first 6 months of a regulatory period would result in a relevant inflation period not being reflected in the estimate. • The asset base is indexed for actual inflation outcomes. We do this by consistently using a lagged series of CPI outcomes through time. The six month 'implementation lag' is applied due to the availability of data at the time of annual pricing. However, as a consistent series is used in the RFM, all past movements in CPI are captured in the asset base.
Adrian Noon, Strategic Economic & Commercial Consultant to CuString Chairman/Principal Lanoon Pty Ltd	**Questions for AER:** 1. In respect of the view that inflationary expectations remain anchored to the 2.5 per cent RBA mid-point, the paper quotes Dr Lally in pointing out that average inflation has been 2.49 per cent from 1994 to 2018. Did or does the AER or Dr Lally consider the possibility however that the Global Financial Crisis (GFC) was such a major global economic event (just as with the COVID-19 crisis now), that it represented a break in series? If yes, as I would	Dr Lally considered that, because reversion to the mid-point of the RBA band is expected to be unusually slow, there is a case for the AER adopting a glide-path providing this slow reversion is expected to be asymmetrical [Lally July 2020, p. 32]. This appears to acknowledge that at least the reversion process may have changed in the short run. While we did not explicitly consider if there was a structural break in the evolution of inflation since the GFC in coming to

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	argue, assessment should also have been taken of the period since the GFC, i.e., since 2008-09. If that had been done, it significantly changes the result down to 2.1 per cent (source: RBA). 2. Since the publication of the draft position by the AER, RBA Governor Dr Lowe announced (Citi Speech last week) that the RBA will be changing its forecasting methodology for the period going forward to change its basis for Monetary Policy targeting from the assessment of inflationary *expectations* to tracking of *actual* inflation. This is a major policy decision by the RBA that challenges long-standing economic theory & policy implementation norms. Has the AER considered the potential implications of this ground-breaking Monetary Policy change in respect of inflation targeting by the RBA in respect of what potentially implies for the Inflation Review, in particular the argument in the paper that actual inflation should be kept separate from inflationary expectations?	our draft position, we did consider if there was evidence that longer term inflation expectations had ceased to be anchored to the RBA band and if the reversionary process (to the mid-point) had changed. Our draft position concluded, consistent with the advice of Deloitte Access Economics, that investors' expectations remain anchored to the mid-point of the RBA target band in the longer-term.. However, we noted that it was likely inflation would take longer to revert to the mid-point of the RBA inflation band [AER Draft position Oct 2020, pp. 47, 57]. It is not clear to us from the Speech by the RBA Governor whether the RBA will be making a change to its inflation forecasting methodology or simply placing more weight on actual inflation outcomes, as opposed to forecast inflation when making monetary policy decisions. However, we will consider any implications of any potential change when reaching our final position.