Public forum Q&A

Regulatory treatment of inflation

July 2020

Inquiries about this publication should be addressed to:

Australian Energy Regulator
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Email: InflationReview2020@aer.gov.au
AER reference: 65487

Invitation for submissions

The Australian Energy Regulator invites interested parties to make written submissions on the regulatory treatment of inflation by close of business, **29 July 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 have commenced a review of the regulatory treatment of inflation (inflation review 2020). In May we published a discussion paper outlining the issues under review.

Interested stakeholders were invited to our first public forum to discuss the issues/matters raised in our discussion paper. The forum was held on 2 July 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
David Havyatt, Energy Consumers Australia	**Question for AER**: It was pleasing to see that the AER recognises the decision about the treatment of inflation should be based on consumers' preferences around managing inflation risk and preferences around regime stability. Given the CRG and consumer advocates have never asked this question of consumers in general, what approach is the AER proposing to assess this consumer preference.	We will consider all material presented, including consumer preferences, to reach a decision that we consider best achieves the National Electricity Objective and National Gas Objective. The CRG has been formed to assist the AER understand consumer preferences.
David Havyatt, Energy Consumers Australia	**Questions for ENA:** 1. Is the ENA presentation ignoring the fact that with uncertain futures there is always a distribution of likely futures, and the regime is entirely built around acknowledging this as it uses tools such as the CAPM that are based on a mean-variance approach to estimation. The fact that at some point in time particular states of nature result in deviations from the mean expectation is totally unsurprising? 2. Is a possible alternative to the AER approach to take debt totally out of the rate of return, and instead treat return on debt as an operating expense? 3. If inflation risk has historically been borne by networks, why is it that the equity beta which is estimated from market data, doesn't fully compensate equity investors for the inflation risk? 4. Does any of the ENA analysis deal with the fact that	**Response provided by ENA**: 1. ENA agrees that it is almost inevitable that actual inflation will differ from forecast inflation. When these two differ, the current approach delivers a regulatory allowance that is either above or below the efficient (nominal) cost of debt, as illustrated in the ENA presentation. Networks will be either under- or over-compensated and consumers will either under- or over-pay relative to the AER's assessment of the efficient cost of debt. If the same inflation figure is used when computing allowed revenues (PTRM) and when performing RAB indexation (RFM) this problem is eliminated for networks and consumers – consumers will pay the efficient cost of debt; no more and no less. 2. Treating debt as an operating expense is equivalent to the case where no deduction is made for inflation when computing allowed revenues (PTRM) or when performing RAB indexation (RFM) – in relation to

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	equity investors have an alternative financing approach of decreasing gearing. 5. What does ENA say to the alternative prospect that the way to balance the outcome for consumers of future consumers paying more to equity investors than current by simply accelerating depreciation since the depreciation schedule is arbitrary so long as the NPV=0 criterion is met?	debt capital. In that case current consumers fund the (efficient) interest bill each year, rather than a portion of it being funded by future consumers. 3. The key risk here is that the AER adopts an unreasonable estimate of expected inflation. It is not clear that this risk is systematic and therefore related to beta. In any event, that risk has been low until recent years. For most of the data period that the AER uses to estimate beta, the AER approach to forecasting inflation was broadly reflective of market data. However, in the last round of resets there is an extremely high degree of divergence between the AER's forecast of inflation and market expectations. This is a new risk that has emerged in the current (extraordinary and unprecedented) market conditions and which is not reflected in the AER's 2017 beta estimates. ENA does not consider that there is a reasonable argument that, even though the AER has never before set regulatory allowances that lock in negative profits, or adopted an inflation forecast more than 1% above the figure from market data, equity investors should have known that such an outcome was possible, and that this has affected historical share prices in a way that increased the equity beta estimates that the AER compiled in 2017. 4. The figures in the ENA presentation are based on the benchmark efficient gearing of 60%. ENA considers that it is not congruent with the regulatory regime that networks should need to depart from the benchmark efficient capital

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		structure to remedy issues caused by the AER’s approach to inflation. Such a change would require networks to issue equity to repay debt (to below the AER’s assessment of the benchmark efficient level) to remedy the fact that the current regulatory allowance is insufficient to pay the (efficient) interest charges on that debt. 5. Accelerating regulatory depreciation can assist with cash flow issues as it moves revenues forward from future periods in a net present value (NPV) neutral way. This does not remedy a poor regulatory forecast though – if the AER’s forecast of inflation is unreasonably high, equity holders will be under-compensated as illustrated in the ENA presentation. That is an NPV<0 scenario, so it is not remedied by moving revenues forward in an NPV-neutral way. In essence, accelerating depreciation returns investors’ capital to them at a faster rate, but does not ensure they receive the return on equity allowed by the AER.
David Havyatt, Energy Consumers Australia	**Question to AER and ENA:** You have both talked about ‘prices’ rather than ‘revenue’ and hence ignoring the volume risk which is now borne by consumers. There is a possibility that the financial risks from economic conditions are correlated – a naïve assumption would imply a low growth environment is one with demand forecasts not being met, so a revenue cap overcompensates the networks when economic outcomes are such that a guaranteed real return potentially undercompensates them. Are the risks correlated? How	**Response from AER:** In reviewing our current treatment of inflation, and the impact of any changes, we will consider the appropriate sharing between consumers and networks of inflation risk, as well as any impact on the sharing of risks across the broader framework. **Response provided by ENA**: It is not clear to ENA that there is strong correlation between financial market conditions and demand – particularly the demand from more vulnerable customers. The current crisis period provides a case in point – where the economy is in deep recession but

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	should that be dealt with?	demand from households has sharply increased. For many distribution networks facing a growing need to replace assets to maintain service levels to customers, expenditure is now far more sensitive to asset condition than to variations in demand. There are also issues that arise from the AER adopting a particular approach to inflation on the basis that it might offset perceived inadequacies elsewhere in the regulatory regime.
Allan Hudson, ATCO Gas	I don't understand why using a nominal revenue model and using a tariff variation formula of CPI-X are mutually exclusive? Would it be possible to have a tariff variation to true up forecast inflation verse actual inflation included in tariffs providing real dollar certainty to consumers?	There are various approaches to target a nominal rate of return in the regulatory framework. Maintaining a CPI-X annual pricing formula may still be appropriate to apply under a nominal target to appropriately share the inflation risks between consumers and networks. As noted in our discussion paper, we would like to hear views from stakeholders about whether we should pursue an alternative target return. If there is broad support from stakeholders to consider a change we would set out the direction of the changes of this option in our draft position for stakeholder feedback.
Allan Hudson, ATCO Gas	Would the AER be able to clarify its understanding of a nominal revenue model please? I gained the impression, perhaps incorrectly, during the discussion around slide 10 at the webinar today with regard to a nominal approach, that a nominal approach precluded using a CPI-X type tariff variation formula.	Our understanding of a nominal revenue model is any model in which the allowed revenues are driven by the expected nominal rate of return, as opposed to the current approach in which the expected real rate of return drives revenues. The application of this may take various forms. For example the asset base may be unindexed, or indexed using forecast inflation. Application of the CPI-X tariff variation may also be applied without impacting the

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	Is my impression correct or have I misunderstood? In North America the practice is to use a nominal revenue model but apply a tariff variation formula to adjust for actual v forecast inflation as well as an X factor.	ultimate goal of targeting a nominal rate of return for service providers. We suggest your explore the simulator available here: https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-treatment-of-inflation-2020/initiation
David Havyatt, Energy Consumers Australia	**Question for APGA**: I understand the perspective that a 100 basis point increase in inflation seems unlikely given that this hasn't occurred at all in the era of RBA inflation targeting. However, since inflation targeting was introduced the RBA's objective has mostly been reducing inflation not increasing it. We also know that the RBA has discovered that monetary policy can reduce inflation but is less effective at increasing inflation. As a consequence the RBA has learnt that it has moved too quickly in the past at increasing cash rates. In other words, why do you seem to expect that the RBA won't be modifying its approach to reflect the lessons from the last two decades of inflation targeting?	**Response provided by APGA**: We weren't making any assumption about what the RBA may or may not do, merely pointing out that the outcome of such rapid increases of inflation has been relatively rare.
David Havyatt, Energy Consumers Australia	**Question to All**: The economic regulation regime is notionally an 'incentive regime.' The formal theory of Laffont and Tirole was built around how to design a system that creates the incentive for the network to reveal its own cost opportunity (an incentive compatible contract). This suggests an alternative approach in which the 'expected inflation' is a variable the network chooses and the network's	**Response from AER:** This is a complex question that should be raised in a submission on our discussion paper. **Response provided by APGA**: This is an interesting idea, and it would be interesting to see how it further develops. Direct application of the kind of menu approach you indicate has had some success in some areas of regulation (I am aware of it working well in the governance of water rights in Pakistan, for example). However, I am not sure how close it would end

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	actual return is optimised by having out-turn inflation match expected inflation. That the goal to be rewarded is matching out-turn is based on the idea that the business has the incentive to help form the inflation expectation of its lenders. I haven't thought through how this might work in the model but I am asking for thoughts on the idea and suggestions on how it could be incorporated in the model.	up being to the RIIO-1 process currently being reviewed in the UK which likewise sought to use the insights of Laffont and Tirole more directly, and the experience of that regime might also provide useful material for further thinking in this regard. **Response provided by ENA**: We would be happy to discuss this idea further.