# AER: Inflation review 2020

Stakeholder forum

**2 July 2020**

Warwick Anderson, General Manager, Networks Finance & Reporting
Eric Groom PSM, AER Board member

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# Welcome

| Agenda item | Presenter | Time allotted |
|---|---|---|
| **Participant connection** | | 9.00 – 9.05am |
| **Welcome/Introduction** | Warwick Anderson | 9.05 – 9.15am |
| **AER presentation** | Eric Groom PSM | 9.15 – 9.35am |
| **ENA presentation** | Charlotte Eddy and Stephen Gray | 9.35 – 9.55am |
| **APGA presentation** | Nick Wills-Johnson | 9.55 – 10.15am |
| **CRG presentation** | Craig Memery, CRG Chair | 10.15 – 10.35am |
| **AER Consultants** | Deloitte Access Economics (Stephen Smith, Sheraan Underwood) | 10.35 – 10.50am |
| | Sapere (Kieran Murray) | 10.50 – 11.05am |
| **Closing** | Warwick Anderson | 11.05 – 11.15am |

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# Consumer Reference Group

- We have appointed the following members to the CRG:
    - Craig Memery (CRG Chair)
    - Allan Asher
    - Helen Bartley
    - Dr Ron Ben-David
    - Joanne (Jo) De Silva
    - Kieran Donoghue
    - Beverley Hughson
    - Alex Oeser.
- CRG membership also includes a representative from Energy Consumers' Australia.

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# Inflation Review – why it matters and why now

- Some of the changes observed in recent months included:

  – A shift in RBA commentary compared to previous statements:

  '*The global outcome of the coronavirus is expected to delay progress in Australia towards full employment and the inflation target.*'

  – Some recent forecasts of the survey measures we monitor have been returning to the mid-point at a slower rate than previously.
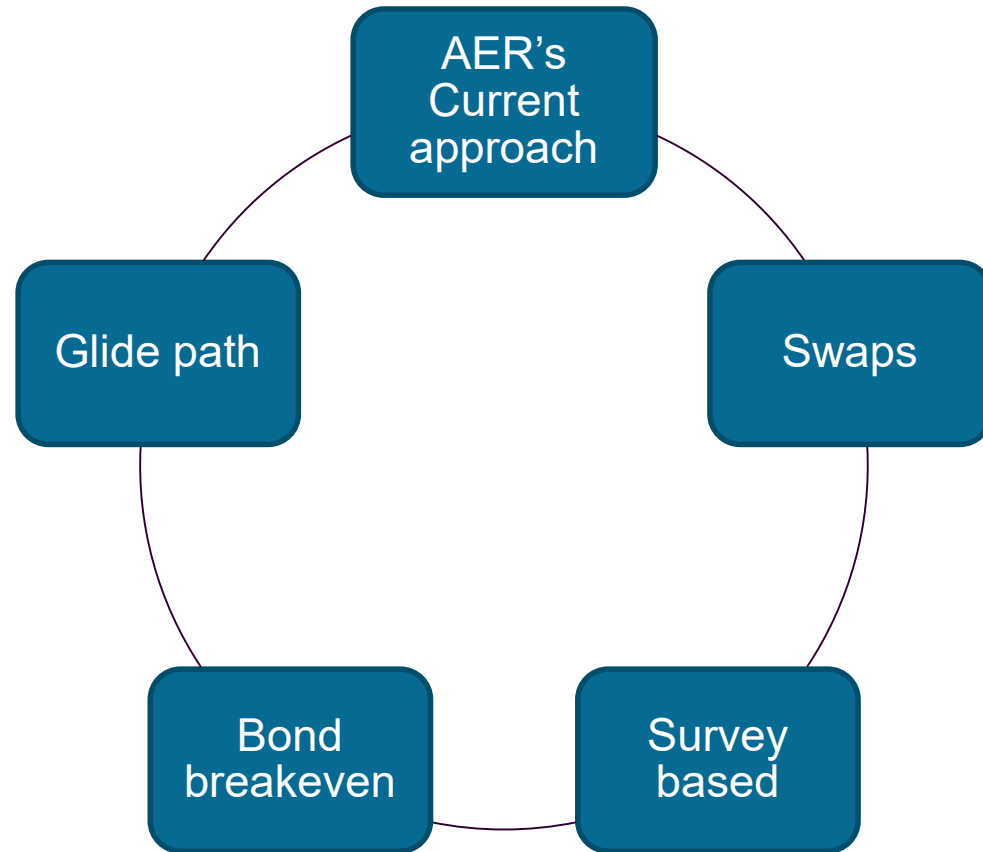
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# Scope of the review

1.  What method should we use to estimate expected inflation? This is an important input into our regulatory determinations.

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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# What is the 'best' estimate?

- We are required to calculate the best estimate of expected inflation possible in the circumstances.
- Expected inflation is the inflation expected at the time of the regulatory determination – an *ex ante* measure.
  - Inflation outcomes (*ex post*) may differ from expected inflation – but this does not change what the *ex ante* inflation expectation was. Nor does it mean the estimate of expectations did not reflect expectations at the time of our determination.

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# Issue 1: Methods to achieve the best estimate of expected inflation

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# Issue 2: Delivery of initial real rate of return

- Delivery of the expected initial real rate of return is successful but not exact.
- Potential reasons for minor deviations include:
  - First year pricing effect
  - Implementation lags
  - Trailing average of debt effect.

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# Issue 3: Changing the regulatory framework

Option 1: Current approach set an initial **real return** and adjust by actual inflation.

- There may be a mismatch if costs are fixed in nominal terms
- Preserves purchasing power

Option 2: Set a **nominal return** and revenue.

- Investors and customers are exposed to movements in actual inflation that may move purchasing power

Option 3: nominal rate of return for *debt* and real rate for *equity* (**hybrid approach**)

- Set return based partially on nominal amount, partially on real amount
- Weights based on portion of costs that are fixed in nominal $
- We still need an estimate of expected inflation
- Does not preserve purchasing power over regulatory period

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# Inflation risk and consumers

- Currently, we set X factors, reflecting <u>*real*</u> change in revenue/prices.
- Ultimate price changes will reflect set X factors and actual inflation outcomes.
  - For consumers: uncertainty over ultimate nominal price/bill.
- If we change to a set nominal return, in effect, we will set the <u>*nominal*</u> change in revenue prices.
  - For consumers: risk that income inflation doesn't align with our projected inflation (built into energy prices).
    - Uncertainty over affordability.

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# Thank you

Please email all questions to:

[InflationReview2020@aer.gov.au](mailto:InflationReview2020@aer.gov.au)