

Initiation notice – 2020 review of inflation approach

We have decided to review the treatment of inflation in our regulatory framework, including the method likely to result in the best estimates of expected inflation. This will allow us to consider possible changes to our approach. The review will be a transparent and consultative process. We aim to reach a final position by December 2020. If that final position recommends changes to our approach, we will implement those changes in 2021.

Background to the review

We last ran a comprehensive review of inflation in 2017. This process included extensive stakeholder consultation through public forums, workshops, and written submissions.

Our final position at the conclusion of the 2017 review was that we would maintain our existing inflation approach. We indicated that we would continue to monitor inflation related data.

Since mid-2019, we have received a number of stakeholder submissions asking us to undertake a new inflation review. Several energy networks have proposed specific changes to our inflation approach as part of regulatory determinations that are already underway.

Why a new review?

Until recently, our ongoing monitoring has indicated broadly consistent observations in the key information we relied on in 2017. We now observe that there have been some movements across the spectrum of data and information we examine.

While no individual piece of evidence is determinative, when considered in aggregate these movements support the commencement of a new review.

Further, commencing the review now means that any recommendations from the inflation review will feed into development of the 2022 rate of return instrument. There are many interrelationships between inflation and the rate of return instrument.

The AER has considered the stakeholder submissions already received in deciding to initiate a review of its approach to inflation. Our reset determinations will address the relevant submissions put to us by each network business.

Scope for the 2020 inflation review

We propose to examine three key issues:

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

Stakeholder involvement

The success of the review will depend on the active involvement of a cross section of stakeholders—investors, networks, retailers and consumers—across the gas and electricity sectors. This is because we apply our inflation approach consistently across all regulated networks and pipelines. We are mindful that stakeholders may have restricted ability to engage in our consultation processes because of COVID-19. We will follow Australian government advice on

public gatherings and provide six weeks for submissions. We will seek to incorporate online forums to facilitate stakeholder engagement.

Timing

The proposed indicative milestones for the review are:

April 2020	Initiation notice
Early May 2020	Discussion paper
May-June 2020	First consultation round
August 2020	Draft position paper
Sept-Oct 2020	Second consultation round
December 2020	Final position paper

We may amend this timetable as the review progresses in order to respond to arising issues, including issues around the ongoing management of COVID-19. Written submissions will likely be due late June and late October 2020.

Implementation phase

A number of implementation processes are possible, depending on the recommendations (if any) in our final position.

If a change to our regulatory models is recommended, we expect model changes could be completed by April 2021.

If a rule change process is required, this will mean that we submit a rule change request to the Australian Energy Market Commission (AEMC). The AEMC would then run a rule change process and consider whether to make a change. This process may take several months.

If we recommend inflation-related changes to how we estimate the rate of return, we will consider these further when developing the 2022 rate of return instrument.

In each of these cases, changes arising from the inflation review would apply to subsequent gas and electricity regulatory determinations on a prospective basis. Any changes would not apply to regulatory decisions that have concluded.

For more information

Documents produced in the 2017 review (such as the 2017 final position paper) provide accessible descriptions of the current AER inflation approach. Stakeholders may wish to familiarise themselves with this material in advance of the publication of the 2020 discussion paper.

Information on the 2017 and 2020 inflation reviews is on our website: www.aer.gov.au. Emails to the inflation review project team should be sent to InflationReview2020@ aer.gov.au.