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Regulatory treatment of inflation
APA submission in response to AER preliminary position paper

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APA Group (APA) appreciates the opportunity to make this further submission on the regulatory treatment of inflation. The submission responds to the paper, *Preliminary position* (the preliminary position paper), issued by the Australian Energy Regulator (AER) on 13 October 2017.

In that paper, the AER advises that its preliminary position is continuation of the current approach to the regulatory treatment of inflation:

- estimation of expected inflation is to continue to use the "RBA Method" (a 10 years geometric average of the RBA's forecasts for 1 and 2 years ahead, and the midpoint of the RBA's target band for inflation for years 3 to 10)
- the Roll Forward Model (RFM) and the Post-tax Revenue Model (PTRM) are not to be amended.

What method should be used to estimate expected inflation?

APA understands the requirement for a forward-looking estimate of inflation in the PTRM, and the AER's desire for that estimate to be consistent with the expectations of inflation embedded in the nominal rates of return on equity and debt used in the model.

A range of methods for estimating expected inflation has been proposed by energy sector stakeholders, often supported by expert economic advisors. Those methods have varying data requirements, analytical intensities, and degrees of transparency. However, none of them seems to be able to consistently estimate expected inflation across a range of market conditions and over extended periods.

We can be confident that, whatever method is chosen, there will be differences between estimates of and actual inflation, which will lead to dissatisfaction with the current method of estimation.

Financial market participants can be expected to update their inflation expectations as new information becomes available about the state of the economy and about government macroeconomic policy settings, and can be expected to update their return expectations using that new information.

However, in current regulatory modelling, the return on equity is to be fixed, at the beginning of a regulatory period, for the duration of that period. There is no updating of equity investor inflation expectations.

In APA's view, in these circumstances, there is value in retaining a simple, readily understood and easily implemented approach to estimating expected inflation such as the RBA Method.

Does the regulatory framework deliver the appropriate compensation for inflation?

APA remains concerned that the way in which in the RFM and PTRM are applied does not deliver the appropriate compensation of inflation.

The use of forecast inflation in the PTRM and, subsequently, the use of actual inflation in the depreciation calculations of the RFM for the regulatory period for which the PTRM was applied will, if actual inflation differs from the forecast, result in a difference between the recovery of capital built into allowed revenue and tariffs, and the recovery of capital assumed in roll forward of the regulatory asset base.

This difference is not corrected through the operation of the tariff variation/price control mechanism.

APA understands that implementation of the proposals it has made for dealing with this issue (in the access arrangement revisions for the Roma to Brisbane Pipeline and the Victorian Transmission System) would lead to inconsistency between the inflation forecast of the PTRM, and inflation embedded in the nominal rates of return used in the model.

If some consistency is to be maintained in the PTRM, then the problem of over-recovery or under-recovery of the regulatory asset base can be resolved by using, in the RFM, the forecast of inflation which was previously used in the PTRM for the determination of total revenue and the initial reference tariffs.

The RFM would be updated for actual capital expenditures but not for actual inflation. No amendment would be needed to either the RFM or the PTRM. The only change required would be a change of policy by the AER to use the forecast of inflation used in the PRTM for a given regulatory period, and not actual inflation, when rolling forward the asset base from that regulatory period to the next.

With this change of policy, the service provider should earn its allowed return on capital and, over an extended period, should recover the capital invested in the regulatory asset base through the regulatory depreciation allowance. This is not the case when the inflation measure used in the RFM is different from the estimate of expected inflation previously used in the PTRM.

If the estimate of inflation for the prior regulatory period is used in asset roll forward, the RFM and the PTRM should, other things being equal, "sterilise" the inevitable difference between an estimate of expected inflation previously made and actual inflation, thereby providing the correct compensation.

Real or nominal rates of return?

The debate about whether the regulatory framework should deliver a real or nominal rate of return is, in APA's view, something of a distraction.

There is no particular method of estimating expected inflation that is demonstrably and consistently better than any other method. A simple, readily understood and easily implemented method, such as the RBA Method, should be used.

The regulatory framework should be amended to sterilise the consequences of the inevitable differences between estimates of expected inflation previously made and actual inflation.

One instance of this sterilisation is the roll forward of the regulatory asset base using, in the RFM, the estimate of inflation that was previously used in the PTRM.

APA would be pleased to discuss with the AER any of the issues raised in this submission. John Williams, Manager Regulatory, is APA's initial contact on the regulatory treatment of inflation. He can be contacted on 08 6189 4594, or at john.williams@apa.com.au.

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