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APA submission on AER draft position on regulatory treatment of inflation

APA Group (APA) appreciates the opportunity to make this submission on the paper *Draft Position: Regulatory treatment of Inflation*, which was published by the Australian Energy Regulator (AER) in October.

The key elements of the AER's draft position appear, to us, to be:

- no fundamental change to the current regulatory treatment of inflation; the way in which inflation is currently taken into account in the scheme of the Roll Forward Model, the Post-tax Revenue Model and the annual price adjustment mechanism is to be retained
- the time period to be adopted for the purpose of estimating expected inflation is to be reduced from 10 years to the length of the regulatory period (typically 5 years)
- the estimate of expected inflation is to be made by applying a linear glide path from the Reserve Bank of Australia's forecast of inflation for years 1 and 2 to the mid-point of the Bank's target band (currently 2.5%) in year 5.

A question arises as to whether the change in method of estimating expected inflation should be implemented immediately, or whether it should be phased in, and the AER has asked for stakeholder views on the issue.

This submission sets out APA's views on the AER's draft position, and on the phasing-in of a change in method.

In an earlier submission on the AER's May 2020 discussion paper on the regulatory treatment of inflation, APA was of the view that the question of how regulated price determination and annual price adjustment were to work in an inflationary environment should be addressed prior to consideration of the method of estimating expected inflation.

The draft position paper has now reinforced our earlier doubts about a workable hybrid approach to the treatment of inflation. We think a nominal approach remains a possibility, but would require further investigation and specification before it could be implemented. In these circumstances, the AER's proposal not to fundamentally change the current regulatory treatment of inflation is, we think, an appropriate way to proceed. The current regulatory treatment has a number of deficiencies, which may be difficult to correct. Nevertheless, it has now been applied for nearly two decades, and is well understood by investors, service providers and consumers.

We expressed concern that when actual inflation is subsequently different from the estimate of expected inflation used in the PTRM, there is either an under-recovery or over-recovery of capital over the life of the regulated asset. We do not find arguments that use of an unbiased estimate of expected inflation will, in the long run, eliminate under or over-recovery of capital to be convincing. The "long run" is undefined, and inherently unknowable. Once seen as very long-lived assets, gas transmission pipelines – still APA's core business – may have a shorter and more uncertain future as community pressures for decarbonisation grow, and are reflected in national energy policy.

The AER's proposal to reduce the time period to be adopted for the purpose of estimating expected inflation from 10 years to the length of the regulatory period (typically 5 years) is, in these circumstances, entirely appropriate. Expected and actual inflation are better aligned, thereby reducing the extent of under or over-recoveries of capital. This should benefit both the providers of regulated services, and consumers of the services they provide.

There are many ways in which an estimate of expected inflation could be made using forecasts and other data for a period of five years. We think that applying a linear glide path from the Reserve Bank of Australia's forecast of inflation for years 1 and 2 to the mid-point of the Bank's target band (currently 2.5%) in year 5, as the AER proposes, is a reasonable way of using the available information to estimate expected inflation.

We acknowledge that in the current economic circumstances, estimating expected inflation over a shorter period (5 years) will result in a lower estimate of expected inflation, and a higher targeted real rate of return. The change in method, if implemented immediately, will lead to an increase in tariffs in the next round of regulatory decisions. A phase-in of the change should limit the impact on consumers. Indeed, as the AER suggests, the change might be deferred to a future date, when inflation is close to the "target" of 2.5%, thereby ensuring no material effect on consumers.

We do not agree that deferral until inflation is close to 2.5% will similarly ensure no material effect on service providers. Service providers have previously under-recovered capital invested, and consumers have benefitted through lower tariffs, because estimates of expected inflation have been too high (and targeted real rates of return too low). This will continue during any period of deferral. Correcting the way of estimating expected inflation to deliver the right outcomes in the future will not correct for past under-recoveries of capital (and will not, as APA has argued, preclude future under or over-recoveries).

When Australian inflation might return to around 2.5% is currently unknown. Deferring the change in the method of estimating expected inflation until inflation is close to 2.5% amounts to indefinite deferral.

When stating its draft position (on page 7 of the paper), the AER advises: *We consider this method is likely to result in the best estimate of expected inflation*. If the AER is of the view that the method of estimating expected inflation which it is now proposing to adopt will provide the best estimate possible in the circumstances, then, in our view, that method and the estimates it produces must be used in applying the rules of the gas access regime. Rule 74 of the National Gas Rules requires that a forecast or estimate be arrived at on a reasonable basis, and represent the best forecast or estimate possible in the circumstances. We think the National Gas Rules preclude the phase-in or deferral of the proposed change in method of estimating expected inflation over a specified, and possibly indefinite, period, with the estimate of expected inflation not being the best estimate possible during the period of the phase-in or deferral.

APA would be pleased to elaborate on any of the views in this submission. Our work on rate of return is being undertaken by John Williams, who is in our Perth office and can be contacted directly on [redacted] or at [redacted].

[redacted]

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