APGA
Australian Pipelines & Gas Association

AER Inflation Estimate

Stakeholder forum on draft position paper

APGA Presentation
21 October 2020

Key points

- Pleased to see some movement on inflation
- Change in estimation approach reasonable; but not best available measure
  - APGA prefers market based measures
- At this stage, APGA accepts AER adoption of new glide-path method
- No need for the proposed transition to the new approach
- AER has missed key benefits of the hybrid model; but APGA recognises this issue will go no further in this review
- There are some issues we believe consumers should raise

The core of our differences

AER – 2017 considered that "eventually" meant 3 years, now consider that it means 5 years

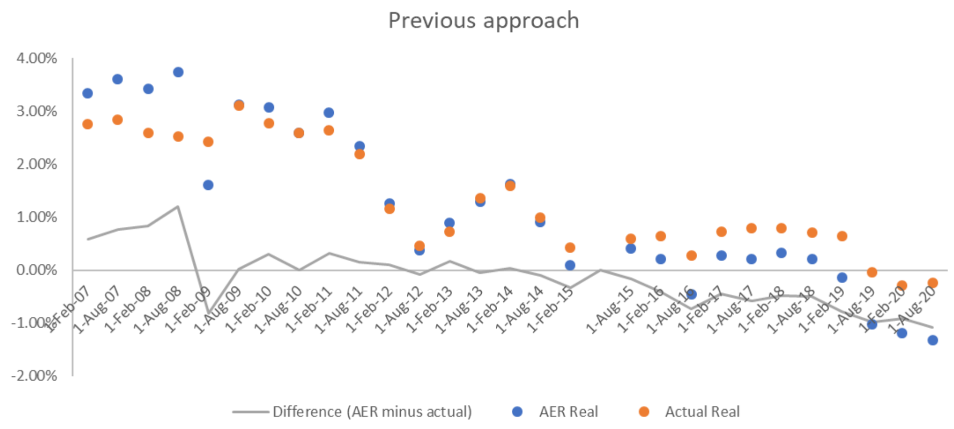
Networks – believe market data suggests that it is longer than 5 years at the moment from their current level.

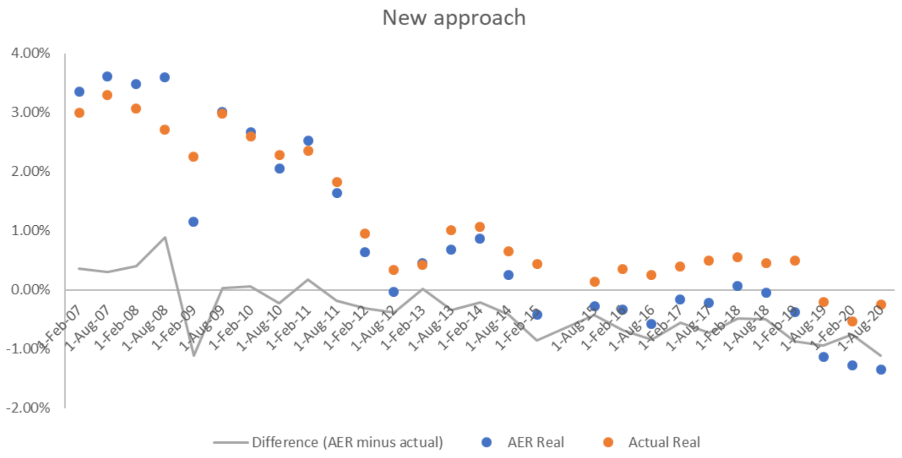
Having regard to the available evidence, our view is that investors' expectations remain anchored to the mid-point of the RBA target band in the longer-term. That is, we consider the evidence supports a position that investors expect inflation should eventually return to 2.5 per cent. This is consistent with our findings in the last inflation review.

Draft Decision p50

We agree with the basic proposition made by the AER above. Our disagreement boils down to what we think "eventually" means and what data we use to inform that view.

Why we consider the estimate is reasonable, not best





- Compare the implied AER expected real CGS with actual real CGS
- New AER approach is a tiny bit better; particularly in early years when AER approach over-stated inflation

The role of market data

- Market data capable of more flexibility on “eventually”
  - AER approach fixes it at 5 years, but market data changes
- Do not agree on strength of bias findings:
  - Agree that market data is systematically different from survey results – this is what the regression results say
  - Disagree this means market data are systematically different from expected inflation, which is not measured
  - Some evidence for some market imperfections at some times, but they are small or transitory because they create arbitrage opportunities
- Disappointed with engagement on this, but learned some lessons
  - Let’s move away from loading on more papers with the same conclusions and discuss what the conclusions actually mean
  - Let’s (all) avoid histrionics (eg p122)
- We propose to follow the advice of Max Planck in further addressing this issue

The role of a transition

AER view	Initial comments
Transition still gives correct compensation over life of asset	But wrong compensation now. Getting the correct compensation each period is better than generating unders-and-overs, from NGO perspective
Avoids potential gains or losses	Does not set a good precedent; means AER would need to transition to, say, a lower MRP in the RORI in 2022
Might allow change to be deferred until there is no impact	There will be an impact until the change is made. The AER would not change beta, say, until it increased again to avoid an impact
Allows AER to simultaneously treat term in inflation and RORI	The term issue is different in each case; mismatch concern (inflation) vs holding period (WACC)
Broad concerns about “windfall gains”	There are no windfall gains if all approaches only use forward-looking data

Not only can we see no reason for a transition, but we cannot see why the AER would have thought that the issue needed debating in the first instance.

The AER’s views on the hybrid

- View that only real return on assets meets the NGR not substantiated
- Hybrid best implements investor desire for nominal debt & real equity returns
- APGA agrees that submission on the hybrid did not map out its every detail, consequence and required technical change
- APGA agrees the AER’s changes to inflation somewhat lessen the concerns the hybrid sought to address
- Propose:
  - Hybrid details can be worked out via a separate process as necessary
  - Remaining concerns about negative equity cashflows & financeability can be addressed through the RoRI process (and not by assuming investors view us like Google)

Some closing thoughts for consumers

- AER concluded that consumers desire stable real returns, but there is no evidence provided
  - Is this supported? If so, why & what evidence informs this view?
- AER concluded it will focus on expected inflation; networks keep the inflation risk premium
  - Currently negative, so consumers benefit
  - However, usually positive
  - Investors in real assets don’t face inflation risk so don’t need inflation risk premium (disagree with AER textbook finding).
  - Do consumers agree that networks should receive this long run benefit?