Draft position paper on the regulatory treatment of inflation

6/11/2020

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1. Summary

The Australian Pipelines and Gas Association (APGA) welcomes the opportunity to comment on the Australian Energy Regulator's (AER) draft positions paper on the regulatory treatment of inflation.[1]

APGA is the peak body representing Australasia's pipeline infrastructure, with a focus on gas transmission, but also including transportation of other products. Our members include owners, operators, constructors, advisers, engineering companies and suppliers of pipeline products and services. APGA's members build, own and operate the gas transmission infrastructure connecting the disparate gas supply basins and demand centres of Australia, offering a wide range of services to gas producers, retailers and users. The replacement value of Australia's gas transmission infrastructure is estimated to be $50 billion.

We are pleased to see the AER review the issue of forecast inflation. A stable, predictable regulatory framework is vital to maintaining the attractiveness of the Australian energy sector as a destination for investment. It is in that context that we make this submission, which we hope can contribute to a future improved investment environment. Our submission responds to the draft position paper.

1.1 This review is important to us

We have previously explained that forecast inflation plays an important role within the current regulatory framework. Clearly, almost all forecasts will invariably turn out wrong. What matters is whether this error is systematic or not.

In our view, the AER's current approach to forecasting inflation does just that – it systematically over- or under- compensates due to flaws in its design. In the current environment, these flaws are leading to it significantly under-compensating regulated gas pipelines and electricity networks.

If this under-compensation persists, then it will significantly undermine how regulated gas pipelines can support Australia's transition to a decarbonised energy supply and deliver the outcomes that our customers want. Our submission to the AER on two recent rate of return working papers explores that transition further and the importance of getting compensation right,[2] and so we will not elaborate further here.

With this backdrop, we appreciate the AER undertaking this review of how it forecasts inflation and reaching a compromise in its draft position papers.

1.2 A value proposition to consumers

We are mindful that, as both expected and actual inflation are currently at historical lows, better reflecting this in forecast inflation – as the AER's proposed approach does – will lead to price increases for consumers *in the current environment*.

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[1] AER, October 2020, *Draft position – Regulatory treatment of inflation*.

[2] APGA, 9 October 2020, *APGA Submission to the AER – Draft working papers on return on equity models and international approaches to the rate of return*.

Although such short-term impacts often grab attention, it is the longer-term benefits of the proposed approach that should be the focus. In our view, consumers will benefit over the longer term in at least two key respects:

- **First**, investors will face more efficient investment signals – leading to more efficient investment being made by regulated gas pipelines that benefit both current and future consumers
- **Second**, consumers will face reduced risk of paying too much or too little for regulated pipeline services – although in a low inflation environment this means that prices will be higher because the current approach overstates expected inflation for the five year regulatory period, the converse is also true with prices lower in a high inflation environment.

Together, these combine to improve efficiency across the energy market – a key objective of the regulatory regime and a key value proposition for consumers over the long term.

1.3 Our view on the draft position

We support:

- the AER's proposed approach – although it could be improved, it reflects a reasonable compromise that addresses key failings with the current approach
- applying it immediately – in our view, it is both inappropriate to apply a transition and inconsistent with the National Gas Rules (NGR) and the National Gas Objective (NGO) to do so.

In our July 2020 submission,[3] we proposed using both market-based measures to forecast inflation and a hybrid approach to adjust how inflation affects the debt funded component of the regulatory asset base (RAB). Although we continue to support these proposals, we recognise that the AER will not pursue them further at this juncture.

Nevertheless, the AER should:

- reflect on how it engaged with our July 2020 submission – in large part, we are not pursuing our position on market-based measures because of how the AER has engaged with the evidence that we and other stakeholders have raised[4]
- consider how to address the concern underpinning our proposal to apply the hybrid approach, which remains unresolved by the draft positions paper.

1.4 Our recommendations

Box 1 below includes recommendations that the AER should consider when finalising its position on forecast inflation.

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[3] APGA, 29 July 2020, *APGA Submission to the AER – Regulatory Treatment of Inflation*.

[4] See, for example, page 122 of the draft position paper where it suggests that the historical forecast accuracy of swap-based estimates of inflation may be due to the presence of biases, premia and other distortions which it believes exist. By not fairly engaging with evidence, such statements suggest to stakeholders that the AER is not interested in engagement on issues like those raised by Spark Infrastructure.

Box 1: Recommendations

1. Retain its proposed approach to forecasting 5-year inflation to make the post-tax revenue model (PTRM) and roll-forward model (RFM) internally consistent.
2. Apply that approach immediately, without a transition.
3. Reflect on how it engaged with aspects of our previous submission, most notably, our proposal to use market-based measures to forecast inflation.
4. Recognise that the financeability concerns underpinning proposals for a hybrid approach have not been addressed – either in this review or other recent reviews – and so should be actively looked at in the 2022 rate of return review.

1.5 Structure of our submission

Our submission is structured as follows:

- Section **Error! Reference source not found.** explains why we are comfortable with the AER's proposed approach
- Section **Error! Reference source not found.** explains why it is inappropriate for the AER to apply a transition to that approach
- Section **Error! Reference source not found.** raises two further matters that the AER should consider – namely, how it engaged with our proposal to use market-based measures and how it should address the concern underpinning our proposal to adopt a hybrid approach.

2. Proposed approach is better

The AER proposes a new approach to forecasting inflation that involves using:

- a shorter horizon – five instead of 10 years; and
- a glide path – where none existed previously.

We support this approach, recognising it as an improvement on the AER's current approach. This section explains why.

2.1 Constructive engagement

In response to significant input by stakeholders, expert advice, and its own investigation, the AER is proposing to change its approach.

Although not all stakeholders will agree with the proposal, we are pleased to see the AER and its staff putting in genuine effort to understand our concerns and to look at alternatives to its current approach. To us, the proposal reflects a compromise of positions put forward by various stakeholders.

2.2 Why the proposed approach is reasonable

As a compromise, the proposed approach makes two key changes to the current approach:

- **First**, it recognises how unrealistic it was to assume that inflation would reach 2.5% after three years (as the current approach implicitly does) – there was just no market-based evidence to support this assumption.
- **Second**, it focuses on inflation over the five-year regulatory period, rather than somewhat ambitiously (and arbitrarily) attempting this over two regulatory periods. This focus on the one regulatory period aligns with how forecast inflation is actually used in the PTRM – namely, to estimate the actual inflation that will be used to index the regulatory asset base at the end of the period and remove this projected indexation from allowed revenues.[5]

Together, these two changes should help improve the accuracy of the AER's inflation forecasts and provide for fairer outcomes to gas pipelines and customers.

The first change means that forecast inflation will respond more effectively to changes in market conditions and expectations to the extent that these are reflected in the RBA's forecasts (which is likely to some degree).[6] Together with the second change, this means that the indexation deducted from allowed revenues over a regulatory period will more closely align with the expected indexation of that RAB at the end of that period – reducing potential errors.

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[5] In other words, aligning the term removes an inconsistency in how inflation is currently used within the PTRM and the RFM. The inconsistency arises because the current approach deducts a 10-year estimate of future inflation from forecast building block revenues in the PTRM, but only provides compensation for actual annual inflation in the RFM over the 5-year regulatory period. The proposed approach removes this inconsistency by using a 5-year estimate in the PTRM as well.

[6] As such, we agree with the AER when it notes that '*estimating expected inflation over five years rather than ten reduces the uncertainty associated with our estimate and gives greater weight to current market conditions*'. See: AER, October 2020, *Draft position – Regulatory treatment of inflation*, p. 20.

Aligning the revenue deduction to the expected indexation helps ensure that gas pipelines are not systematically over or under compensated, or customers over or under charged, for efficient costs. This helps promote efficient investment and ensures fairer outcomes over the longer term.

Although, in the current environment, the current approach is under compensating gas pipelines and under charging customers for efficient costs, the reverse will play out in other environments. Making the change helps remove forecast error from the AER's decision making.

As well as removing error, estimating expected inflation over five years rather than 10 also makes sense in theory. Here, we agree with Dr Lally's reasons for why the AER should estimate expected inflation over five years:[7]

> *Dr Lally proposed this change because:*
>
> - *The use of a five-year term for the estimate of expected inflation ex-ante matches the indexation of the RAB for actual inflation over the regulatory period.*
> - *Using a five-year term for the estimate of expected inflation when the regulatory cycle is five years provides for net present value (NPV) neutrality if a five-year rate of return is also used. In this scenario, there will be no significant gain or loss for a service provider or consumers.*
> - *It is appropriate to use a five-year term for the estimate of expected inflation even if you use a ten-year time horizon for estimating the rate of return. This is because the rate of return is generally upward sloping, while an estimate of expected inflation is as likely to be downwards as upwards sloping. Therefore, there is no benefit of using a ten-year estimate of expected inflation over a five-year estimate.*

2.3 Why we think there is still room for improvement

Although reasonable, in our view the proposal is not the 'best' approach open to the AER. Further improvements could be made, for instance, to:

- include market data (such as from swaps) which provides a better indicator of what the market expects than the RBA does
- recognise that, in the current economic environment, it is likely to take longer than five years before 2.5% is reached – even the AER's own advisors expect this.[8]

We discuss the first improvement further in section 4.1.

Elaborating slightly on the second improvement, the draft position paper reasons that:[9]

> *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*

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7 See: AER, October 2020, *Draft position – Regulatory treatment of inflation*, p. 19. Footnote references omitted from the quote.

8 See: Deloitte Access Economics, 11 August 2020, *Wage Price Index forecasts – Prepared for the Australian Energy Regulator*. Table ii, p. xiii. The table includes forecast inflation starting at 1.3% in 2019-20 and increasing to 2.2% by 2025-26.

9 AER, October 2020, *Draft position – Regulatory treatment of inflation*, p. 50.

2.5 per cent. This is consistent with our findings in the last inflation review. [Emphasis added]

We agree with this general proposition.

Our concern is over how the term 'eventually' is given effect. The AER's current approach deems this as occurring in year three. The proposed approach shifts this to year five – an improvement.

However, in our view, rather than stick to a fixed target of 2.5% by year five, the estimated length of time before a return to that target should be informed by market data – currently that data suggests it will take longer than five years to reach 2.5% inflation.

Other stakeholders will no doubt have different views on either of the potential improvements raised above. In any case, to us, the proposed approach reflects a compromise that we can accept at the current time as it will help reduce the systematic under compensation faced by gas pipelines today.

3. Transition is inappropriate

The draft positions paper considers whether a transition to the proposed inflation forecasting approach is needed.

In our view, no such transition is needed, nor permissible – indeed, including one would undermine the objectives of the regime. This section explains why.

3.1 A transition has no role

The AER explains that it is considering whether a transition is needed given the change in approach 'may create a once-off impact for service providers and consumers'. [10] It goes on to list potential advantages of applying a transition or not.

We are concerned by this focus. Changing the approach to forecasting inflation will have an impact – that is, indeed, the reason for doing so. Introducing a transition simply because there *is* a change does not make much sense as a matter of regulatory practice (unless it is to support behavioural change). [11] The AER regularly changes its estimation approaches across a wide range of inputs to its revenue determinations without introducing transitions. Applying one here but not when other changes are made appears arbitrary.

We are also concerned that the AER is even entertaining the potential for a transition. In our view, a transition to using the best estimate for regulatory decision making has no role to play under the NGO nor the NGR.

When introducing its discussion on a potential transition, the AER notes that it is:[12]

> *considering this in the context of which approach is likely to result in the 'best estimate' of expected inflation in the context of achieving the NEO and NGO.*

This is the right way to think about it – how to get the best estimate of expected inflation. As well as promoting the NGO, achieving the best estimate is also consistent with the NGR. Specifically, rule 75B(2)(b) requires that the PTRM includes 'the method that the AER determines is likely to result in the best estimates of expected inflation', which says nothing about whether a five or 10 year term is required.

If – as the AER explains – its proposed approach using a five year term is 'likely to result in the best estimate of expected inflation', [13] then it simply does not make sense to apply a transition to it. Such a transition would effectively delay the point when the best estimate can be achieved – which can hardly be said to promote the NGO, nor be consistent with the NGR.

Moreover, rule 75B(2)(b) is clear that the PTRM should include *the* method that gives the best estimate. It is not open to the AER to implement a transition to achieve this. As discussed in the

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10 AER, October 2020, *Draft position – Regulatory treatment of inflation*, p. 69.

11 Good regulatory practice would generally only consider applying a transition where there was a demonstrated benefit from giving time to allow for behaviour change, or otherwise an explicit requirement to do so. Examples may include giving consumers time to price signals, or businesses time to align debt management practices or find sustainable cost savings. There would be no such behaviour change benefit from applying a transition to methods used to forecast inflation as far as we are aware.

12 AER, October 2020, *Draft position – Regulatory treatment of inflation*, p. 69.

13 AER, October 2020, *Draft position – Regulatory treatment of inflation*, p. 7.

next subsection, this contrasts with previous rule 87(10) and rule 87(19), which explicitly allowed for a transition from one return on debt methodology to another.

For these reasons, we consider it inappropriate for the AER to even be contemplating a transition, *unless* it can be said that a transition gives the best estimate. However, in that case, a transition would need to apply every time it forecasts inflation – which would not make sense either as it would then not be a transition. A logical inconsistency.

In our view, a transition is simply not permitted by the NGR. As such, we disagree with the AER when it says '[w]hether to apply a transition is a matter of regulatory judgement'. [14] The rules do not allow for a transition.

3.2 A contrast with return on debt

In its 2013 rate of return guideline, the AER introduced a transition from the on-the-day approach to estimating the return on debt to a trailing average approach. Although some stakeholders disagreed with this, the NGR at the time did allow for one.[15]

Specifically, at that time, rule 87(10) said that the methodology used to estimate the return on debt could, without limitation, reflect:

- a prevailing return on debt
- a trailing average return on debt, or
- some combination of the two (of which a transition between the two would be).

Rule 87(11)(d) required the AER to have regard to any impacts on the benchmark efficient entity if there were a change in return on debt methodology. Rule 87(19) went on to say that the rate of return guideline should indicate how transition issues will be dealt with.

Guided by this flexibility and the need to consider the impact of any change in methodology on the benchmark efficient entity, the AER adopted a return on debt transition. The AER did not apply a transition to any other changes that it made to the way it sets the allowed rate of return (e.g. MRP, gamma or equity beta), just the return on debt.[16]

No such flexibility or considerations exist under the rules when forecasting inflation. Rather, as noted above, rule 75B(2)(b) clearly requires that the PTRM includes the method that the AER determines is likely to result in the best estimates of expected inflation. This refers to a single method and does not allow for a transition.

Moreover, the rationale for applying a return on debt transition does not apply to forecast inflation. In that case, the AER was changing from estimating a prevailing return on debt to estimating a trailing average return on debt. A transition was needed to move the theoretical financing practices from one approach to another – and so a behaviour change was sought. The concern there was that there could be windfall gains or losses for businesses that financed their debt one way and gained or lost from a change to how they were compensated for it. Importantly

[14] AER, October 2020, *Draft position – Regulatory treatment of inflation*, p. 70.

[15] We recognise that rule 87 has since been amended to simply reference the allowed rate of return determined under the rate of return instrument manded by the NGL.

[16] The same applied to the AER's 2018 rate of return instrument where only the return on debt was transitioned.

– if realised – such a windfall gain or loss would be obtained because the trailing average went back 10 years, and thus the debt risk premia in the case of no transition would have been known to the network at the time.

That rationale – and the behaviour change that underpins it – does not apply here where the AER is considering whether to transition from one approach to forecasting inflation to another approach. Financing practices are not changing. There is also no known historical information involved.

3.3 Why a transition is not needed in any cases

Even if a transition *were* permissible under the NGR, then the advantages for not including a transition clearly outweigh the advantages for doing so.

The draft position paper lists four advantages for including a transition. For the reasons set out in Table 3.1, these do little to support the case for a transition. In contrast, the potential advantages of *not* including a transition – as set out in the paper – remain entirely appropriate.

Table 3.1: Our view on proposed advantages for including a transition

Potential advantage	Our view

1. Transition should still result in correct compensation in NPV terms over the life of the assets. In this sense, it should still result in efficient investment.	• Strictly speaking, this is not an advantage of applying a transition.
	• Rather, if true, it simply means that there is no NPV difference between applying a transition, or not applying a transition, or not changing the approach at all – as such, this 'advantage' applies equally to not applying a transition.
	• In any case, there is no clear basis for the presumption that a transition should give the correct compensation in NPV terms over the life of the assets.
	• Logically, if:
	  • forecast inflation affects the compensation that gas pipelines receive, and
	  • the AER's proposed approach gives a better estimate of forecast inflation than its current approach,
	then adopting the proposed approach will mean that compensation better aligns with investment costs.
	• The only exception to this would be if forecast errors from applying the current approach can be expected to offset each other in an NPV neutral way for a given investment.
	• However, no evidence has been provided to support that proposition.

Potential advantage	Our view
	• Even if it were true (that it were NPV neutral), it does not make sense adopting a forecasting approach that produces worse inflation estimates as this could lead to meaningful periods of under or over compensation, which would undoubtably concern stakeholders. • As we discussed in our recent rate of return submission,[17] regulated gas pipelines will be significantly adversely affected by an extended period of under compensation – undermining how they can support Australia's transition to a decarbonised energy supply and deliver the outcomes that our customers want.
2. Transition avoids or reduces any potential gains or losses that may occur as a result of an immediate change in methodology. In particular, it would avoid or reduce any potential impact of an immediate change in our upcoming decisions where the new approach is likely to change the present value of revenue over the next regulatory period.	• This 'advantage' appears to only be an advantage to one set of stakeholders – those that would avoid or reduce a potential loss if a transition were applied. • By listing this as an advantage, the AER is favouring those stakeholders over others – which appears inconsistent with its statutory objective. Stakeholders that would face a potential gain (e.g. reducing under compensation) from a change in methodology suffer from having a transition applied.[18] • Moreover, changing a forecasting approach is *by design* intended to have an impact – implementing a transition to avoid this impact makes little sense and ultimately undermines the NGO by delaying when the method that (in the AER's view) gives the best is applied.[19] • Supporting behavioural change may be one reason for a transition – however, that does not apply here (unlike the case made by the AER when adopting a return on debt transition).

[17] APGA, 9 October 2020, *APGA Submission to the AER – Draft working papers on return on equity models and international approaches to the rate of return*.

[18] Interest rates and allowed rates of return are at record lows. When paired with inflation forecast using the AER's current approach, investors in regulated gas pipelines and electricity networks are earning negative returns. Adopting more appropriate estimates of forecast inflation is a key way to ensure that efficient investment is not undermined – a gain to both consumers and regulated businesses.

[19] Importantly, the proposed change that we are talking about is intended to make its regulatory decisions better by providing more appropriate compensation (whether more or less). Delaying the impact of that change by applying a transition means that decisions will give less appropriate compensation. This does not appear to promote the NGO as best it could, which seeks to promote efficient investment in gas pipelines. Setting allowances either too high or too low by under or over forecasting inflation compared to what a better estimate would give, can only serve to distort investment decisions.

Potential advantage	Our view
	• There is also a real risk of the AER introducing inconsistencies into its decision making by adopting transitions in some cases, but not others – this should be avoided.[20]

3. Depending on its form, a transition may allow the change to be deferred to a date where there is no material expected cost to consumers or service providers from the change.	• A transition that defers applying the proposed approach until there was no expected cost is both imprecise and inappropriate.
	• It is imprecise for two reasons:
	  • **Expected cost is a multi-period concept.** Even if the current and proposed approaches gave materially similar inflation forecasts just prior to the start of a regulatory period, this does not mean that the expected cost is zero. What matters is what compensation the two approaches are expected to apply over *all* future regulatory periods. Recognising this in the transition would be difficult.
	  • **Unclear how it would apply to individual determinations.** As well as being imprecise in general, it is also hard to see how such a transition would apply in practice. Given that forecast inflation is determined at different times for different service providers, the transitions for each would differ. In some cases, it could take multiple regulatory periods before the right conditions presented such that there was no material expected costs to consumers or service providers from the change.
	• It is inappropriate because such a transition would effectively mean that a change is only made when there is little benefit from doing so – simply waiting until this difference is not material would appear to completely undermine the rationale for changing the forecast method in the first case
	• It is precisely because there *is* a material impact that stakeholders have raised concerns about flaws with the current methodology and why the change needs to be

[20] Absent a behaviour change benefit, if the AER sought to apply transitions whenever there was a potential gain or loss, then logic would suggest that it should apply a transition to any change that it makes (e.g. if it were to change rate of return parameters, for instance). To do otherwise would introduce an inconsistency into its decision-making processes that is both hard to understand and could undermine confidence in the regime.

Potential advantage	Our view
	made now in order to better promote the NGO and satisfy the NGR.
4. Transition allows the AER to simultaneously consider the appropriate term for rate of return in the upcoming rate of return instrument process. If the AER decides to change the term used in the rate of return, it can change inflation at the same time and avoid any potential ex-ante mismatch.	• This advantage appears to be based on the premise that the term for forecasting inflation should align with that underpinning the rate of return. • However, there is no basis in the NGR or NGL for this premise.[21] • Within the building blocks, forecast inflation is used to calculate the forecast indexation of the RAB that is removed from allowed revenues – and this applies over a five-year regulatory period. [22] • Given this, it makes sense for inflation to be forecast over a five-year period as is reflected in the AER's proposed approach so that the PTRM and RFM are internally consistent – but the same logic does not apply to the rate of return, which is intended to reflect efficient financing practices.[23] • As such, it is inappropriate to link the term for forecast inflation to that for the rate of return – it is even more inappropriate to set a transition that waits until the next rate of return review before applying the new forecasting approach.

[21] For instance, forecast inflation is referred to in the NGR only when referring to the projected RAB roll-forward and the PTRM. There is no direct link between the term underpinning the inflation forecast and that used for the rate of return.

[22] Forecast indexation is eventually replaced with actual indexation when the RAB is rolled forward at the end of such a period.

[23] As considered during past rate of return reviews, the efficient financing practices for long-lived infrastructure businesses is to use long-term debt and equity financing.

4. Other matters to consider

Although – as explained earlier – we support the AER's proposed approach for forecasting inflation, we do have some observations about it and the AER's justification for it.

Specifically,

- **First**, we are concerned with how the AER engaged with our submission on market-based measures. Using this as an example of what to avoid, we want to work with the AER on how we can improve the sharing of ideas in a constructive way that improves stakeholder confidence and otherwise promotes the NGO.
- **Second**, although the AER has rejected the proposal to adopt a hybrid approach, the concern underlying that proposal remains very much alive. The AER should actively look to address that concern through other reviews, including the recently initiated 2022 rate of return review.

These matters are discussed below.

4.1 Market-based measures

Previous submissions made clear our support for using market data to forecast inflation.[24] The draft positions paper rejects using such data, for now at least.

Without relitigating our case, we do want to highlight our concern with how the AER engaged with our submission.

Our *key point* was that studies of bias in market-based estimates do not actually prove bias. Rather, most of the literature alleging bias simply compares those estimates to survey estimates – neither of which is any more than a proxy of investor expectations. We do not disagree that these two proxies are different, but an objective examination of the evidence gives no reason to expect that one of them is a "true" measure of investor expectations. Measuring bias by reference to survey estimates simply measures how well market-based estimates predict those estimates, not the true expected inflation.

By making this point, our intent was to spark a constructive debate with the AER where we could work through the relative pros and cons of different information sources. We intentionally avoided procuring further expert material in an effort to step away from past practices, avoiding cognitive bias like those that we discussed in our submission on two recent rate of return working papers.[25]

Promoting such debate does not mean that the AER or other stakeholders have to agree with our view that market based measures are the most appropriate; yet we do expect that the AER should engage with what is put forward in a fair and meritorious way.

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[24] See, for instance: APGA, 29 July 2020, *APGA Submission to the AER – Regulatory Treatment of Inflation*, p. 3.

[25] APGA, 9 October 2020, *APGA Submission to the AER – Draft working papers on return on equity models and international approaches to the rate of return*, pp. 17–18.

In our view, this did not happen. Instead, the draft positions paper pointed to remarks made by the ACCC's Regulatory Economics Unit (REU) that: [26]

- unfairly characterised our submission as simply attempting to cast doubt on the literature rather than, say, seeking to understand the quality of that evidence
- discounted our submission because it was not supported by decomposition studies and other evidence, rather than recognise that simple point that comparing two proxies for the true expected inflation does not necessarily say anything about whether either proxy is a better measure of that true value.

Those remarks appear to fall into the trap of seeking to defend a preferred position, rather than genuinely engage with the points raised.

We raise our concern not to re-litigate our point. We recognise that the AER's view appears fixed against placing any weight on market-based estimates of forecasts. Instead, we do so because we see room for the AER to improve how it deals with stakeholder submissions.

There *must* be a better way for stakeholders and the AER to engage on issues like this. Clearly, we must accept some blame – past submissions may have talked past the AER or otherwise used unhelpful language like the REU. We are looking to be much more constructive now.

It is unclear to us exactly how best to improve such engagement, but we would like to work with the AER on this – most particularly as we believe that the pathway to better engagement is a two-way street. For this reason, we have not sought to push back against every claim made by the AER on market data and are treating it as an area where we are effectively agreeing to disagree.

The first step would be for us to have an open dialogue with the AER. We see material benefit in doing so before we get too far into the 2022 rate of return instrument review that the AER commenced recently.

4.2 Hybrid approach

In our view, the hybrid approach would benefit consumers in the long run as it matches the way efficient debt and equity finance is raised – reducing the risk of a mismatch. However, the AER does not appear ready to move on this.

We do not wish to re-litigate this matter further here. However, we *do* want to point out that a key reason for raising it was that there is an inherent mismatch between how efficient financing costs are incurred and how they are compensated for through the regulatory framework, as applied by the AER. This mismatch risks undermining efficient investment by under- or over-compensating debt financing costs, and under or over charging customers for them – which, in our view, does not promote the NGO.

Given that this concern remains unresolved, the AER could actively seek to address it in other forums, including its 2022 rate of return instrument review. To that end, we are encouraged that the AER intends to publish a working paper on low interest rate environments. We welcome the opportunity to discuss the issue further then.

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[26] AER, October 2020, *Draft position – Regulatory treatment of inflation*, pp. 110–111.