Mr Warwick Anderson
General Manager, Networks Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra, ACT 2601

Aurizon Network Response to AER Draft Position Paper on Regulatory Treatment of Inflation 2020

12 November 2020

Dear Mr Anderson,

Aurizon Network welcomes the opportunity to further contribute to the Australian Energy Regulator's (**AER**) review of the Treatment of Inflation 2020 (**the 2020 Review**) in responding to the Draft Position Paper.

Aurizon Network welcomes the AER's recognition that the current assumption that inflation reverts to the midpoint of the Reserve Bank of Australia's target range of 2% - 3% within 3 years will not produce the best estimate of inflation where market conditions are subject to either high *or* low inflation environments.

In addition, the proposal to align the term of the inflation estimate with the term of regulatory asset roll-forward removes a material source of error in respect of the presumption that the regulatory model is consistent with achieving a real rate of return where the shorter term inflation expectations materially differ from the longer-term expectations. Therefore, Aurizon Network supports the draft position to reduce the estimation period for inflation to 5 years.

Regarding the AER's request for views on whether this change should be subject to a transitional implementation there would appear to be no substantive justification for such an arrangement for the following reasons:

- if the AER's draft position produces the best estimate of the market expectations for inflation then it is necessary to adopt that draft position in order to ensure the National Electricity Objective is being satisfied; and

- any potential reduction in the market expectations of inflation from the application of the AER's draft position is a function of the current market conditions and the low inflation forecasts embedded in the risk-free rate. It would be erroneous to consider the price impacts to consumers from implementation of the draft position in isolation of the substantive consumer price benefits arising from the lower risk-free rates.

The draft position relies primarily on the conclusion from its prior review of the regulatory treatment of inflation in 2017 that market based measures of inflation expectations such as inflation swaps and bond break even inflation rate are subject to biases and premia which render them unreliable. However, this analysis in the 2017 review was with reference to instruments having a term of 10 years. As such the AER has not undertaken the necessary empirical analysis to demonstrate the presence of any biases or premia in those same market-based measures of inflation over the term of 5 years that the AER is proposing to use as the assessment period.

Aurizon Network's initial submission to the AER demonstrated that for the period of 2009 to 2020:

- over a term of four years the market-based measures had a lower root mean square error than the 2-year inflation forecasts and the midpoint of the RBA target band for the remaining term; and

- the RBA's second year forecasts demonstrated considerable bias (due to persistent and material asymmetric error).

The AER's response to this assessment was:

> *Aurizon concentrated on a relatively narrow sample period of December 2009 to December 2018 - it is unclear why Aurizon picked this narrow sample period. Lally adopts a sample period that commences near the start of inflation targeting in 1994 to 2019.*

Aurizon Network's selection of this period was explained in its initial submission. It is widely recognised by market participants, including the RBA, that there was a substantial improvement in the depth and liquidity in indexed bond markets from 2009. Therefore, Lally's assessment may be unreliable as it is based on analysis which includes data on indexed bonds over a period where there has been a significant and material structural change in that bond market.

The AER may wish to undertake a more fulsome assessment of bias and premia within all feasible methods, including those potentially present in the RBA forecasts such as:

- timing bias associated with lag between the RBA forecasts and the market averaging period;

- policy reinforcement bias and optimism bias associated with the RBA performance in promoting and achieving its inflation targeting goals.

Having undertaken such a further assessment, if the AER concludes that the glide path approach is the best approach to estimating market expectations then the AER should consider setting the inflation anchor at year 5 having regard to other measures of long-term inflation forecasts such as those published in the RBA's Statement of Monetary Policy.

Furthermore, it must be noted that there is no conclusive recent empirical evidence that long term inflation expectations are anchored at 2.5%. The RBA monetary policy objectives[1] do not explicitly require the RBA to achieve that objective and given the timeframes over which inflation has persistently remained below the inflation target lower bound, prior studies provide limited empirical support for anchoring at the mid-point. The periods used in those studies do not include extended periods of deviation from the targeting objective. While long term inflation expectations may align with the RBA target range of 2% - 3% as a matter of course, there are more reliable forward-looking measures of inflation expectations over the medium to long term, such as surveys and the term structure of market-based measures. These measures may prove more reliable predictors of actual inflation outcomes than reference to the RBA target range or backward-looking measures such as historical averages.

Should you have any questions in relation to this submission please contact Dean Gannaway at [redacted].

Kind regards,

[redacted]

Jon Windle
Manager – Regulation
Aurizon Network.

[1] The September 2016 Statement of Conduct of Monetary Policy states that "They [The Treasurer and the RBA Governor] agree that an appropriate goal is to keep consumer price inflation between 2 and 3 per cent, on average, over time'. In this regard, the average inflation outcomes need only fall between the 2 – 3 range, not that the average should be the midpoint of the target range. Accessed at: https://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-7-2016-09-19.html