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

Dear Warwick

Re: Regulatory Treatment of Inflation – Preliminary Position Paper

AusNet Services welcomes the opportunity to make this submission in response to the AER's Preliminary Position paper on the Regulatory Treatment of Inflation. The role of expected inflation in the regulatory framework is an important issue that has been raised by a number of networks, including AusNet Services, in recent determination processes.

AusNet Services considers that the consultation undertaken by the AER has been a useful exercise and has helped to build common understanding amongst stakeholders on a complex issue.

In our submission to the AER's discussion paper, we identified the potential for two mismatches in expected inflation inputs in the current framework, being:

- The expected inflation implicit in the nominal rate of return, and the inflation forecast used to calculate regulatory depreciation; and
- The inflation forecast used to calculate regulatory depreciation, and the actual inflation used to roll forward the RAB.

AusNet Services understands that the AER considers that the second mismatch is not a concern[1], and (as long as the first mismatch does not arise) overall the framework will operate to deliver an appropriate real rate of return over the long run. The remainder of this submission focuses on the first mismatch.

If expected inflation implicit in the nominal rate of return does not match that used to calculate regulatory depreciation at the beginning of the regulatory period, the framework will misestimate the real rate of return which is consistent with the allowed nominal rate of return (or the 'correct' real rate of return). This is a material issue, and has been highlighted in recent regulatory determination processes where market-based estimates of inflation (including the breakeven approach) have been significantly different to the inflation forecast derived using the RBA short term forecasts and the target band (the current approach).

To minimise the forecasting error risk for both consumers and networks that arises from this mismatch, there is a need to derive the best estimate of inflation *as embedded in the nominal rate of return,* rather than just the 'best' estimate of inflation.

[1] AER, Preliminary Position Paper – Regulatory Treatment of Inflation, p 69

The ACCC recognised that 'the main disadvantage of the current approach is that it is not a market-based method that reflects daily mark-to-market expectations of inflation over a 10 year horizon'[2]. This potential lack of congruence with market expectations is a fundamental flaw in the current approach, as it potentially impacts the delivery of the 'correct' real rate of return. It is important to note that, even if over the long-run, market expectations of inflation are consistent with expected inflation derived using the current approach, key components of the nominal rate of return are set over very short (10-20 day) averaging periods. Market expectations of inflation captured during these short periods materially impacts whether the 'correct' real rate of return is achieved.

While expected inflation embedded in the nominal rate of return is not directly observable, AusNet Services maintains its position that the breakeven approach (being a market-based estimate of inflation) is likely to provide a more accurate indication of inflation expectations of investors embedded in the nominal rate of return, than the current approach. It is possible that a superior outcome may be achieved by quantifying and adjusting for identified biases in the breakeven approach compared to the current approach, despite this adding complexity, given the materiality of misestimating the real rate of return.

Despite these concerns, AusNet Services acknowledges that the AER does not intend to change its approach to the regulatory treatment of inflation at this time. However, we support the AER's intent to monitor the Consensus Economics survey for evidence of a deviation of the series away from the RBA's target band. This would potentially indicate an unanchoring of inflation expectations. As the AER notes, the Consensus Economic survey is proprietary so most stakeholders do not have access to its results. AusNet Services considers it would be useful for the AER to include an assessment in its Final Position paper of whether previous survey results deviated from the RBA's target band between 2013 and 2017. This would help build understanding around the issues raised in this review process.

Glide path

The AER has expressed interest in seeing additional evidence on the merits of adapting its current approach to include a glide path. AusNet Services does not advance any additional evidence in this submission but considers that this may be an issue where stakeholders interested in this approach (including networks and consumers) could work with the AER to assess the existing evidence base and, if there is appetite, potentially jointly commission an expert report.

Please contact Charlotte Eddy, Manager Economic Regulation, on 03 9695 6309 with any questions in relation to this submission.

Sincerely,

Tom Hallam
General Manager Regulation and Network Strategy
AusNet Services

[2] ACCC/ AER Working Paper Series No. 11, p.95, para 205.