Chair & Board Members
Australian Energy Regulator
Level 17 / 2 Lonsdale Street
Melbourne VIC 3000

1 September 2020

Dear Chair & Board members

AER Inflation Review

We write to you because we are profoundly concerned about the fundamental changes to the regulatory framework being pursued by network service providers ("the networks"). We acknowledge the current economic climate poses difficult and uncertain circumstances for price regulation, but without detailed and holistic consideration of the consequences, we challenge the networks' assertion that structural changes to the regulatory framework are required.

Nonetheless, we would welcome a holistic review of the regulatory framework. The current two-year program of reviews enables networks to pursue parameter-by-parameter 'tweaks' to the regulatory model. This allows networks to 'cherry pick' the parameters that will provide them the greatest rents, echoing the greatest weaknesses of the now defunct limited merits review process. They, and in turn the AER, will spend small fortunes exploring and debating the merits of these tweaks.

In contrast, even organised and dedicated consumer organisations lack the resources to fully and effectively engage with the minutiae of the regulatory framework. The AER has attempted to address this in appointing the Consumer Reference Group (CRG), yet even this CRG's resources are dwarfed by those being marshalled by the networks.

Two largely unrelated issues are the subject of this review. First, the appropriate method for estimating inflationary expectations to be used by the AER in its revenue models. Second, the ongoing effectiveness of the real rate of return model for the PTRM. The latter contemplates changing from a real rate of return on debt to nominal rate of return, whether via the network-proposed changes to the roll-forward model (RFM) or by some other mechanism. This proposed 'hybrid' approach is new with no identified precedent worldwide.

Independent research commissioned by the AER demonstrates there is no correct method for estimating or incorporating inflationary expectations in the regulatory framework. It unavoidably requires the AER to exercise its judgement. From our experience and recent consultations with consumer advocates, we believe confidence in the regulatory framework is undermined when 'tweaks' to the model appear to be the product of networks' relentless lobbying. Tweaks to the treatment of inflationary expectations considered in the review risk falling into this category.

The AER is required to make decisions that promote the long-term interests of consumers. This implies genuine and deep engagement with consumers to understand their preferences, particularly

where trade-offs are involved. However, submissions from networks positing structural change do not appear to be supported by direct evidence of consumer engagement.

Networks have not adequately demonstrated a persistent bias in the AER's estimation of inflationary expectations in its numerous regulatory decisions. The networks simply assert that in the *present* circumstances, the AER's approach may overestimate inflationary expectations. Regardless, the key issue is whether the AER's approach is subject to a structural bias.

The CRG is concerned the AER's planned schedule of reviews isolates decisions regarding the treatment of inflation from other decisions affecting networks' regulated revenues, particularly parameters in the rate of return instrument. We fear these incremental decisions, when viewed holistically after two years, are unlikely to produce better outcomes for consumers.

The proposed shift to a hybrid approach would fundamentally alter the way inflationary risk is addressed under the regulatory framework. The hybrid model would eliminate inflationary risk on 60 per cent of a network's finance allowance, whereas the current approach sees this risk managed over the business cycle. The current regulated allowance for equity partially reflects an expectation that networks will manage business cycle risk. Clearly, ameliorating this risk under a hybrid approach should have commensurate bearing on the regulated return provided to equity under the rate of return instrument.

The CRG considers no case has been made for changing the method for estimating inflationary expectations, or its treatment in the AER's revenue models, and expects the reasoning behind any proposed changes to methodology to be fully explicated in the AER's draft inflation determination.

The CRG will assess any proposed changes, take into account the following:

- whether the AER provides conclusive evidence of a persistent bias in its methodology for estimating inflationary expectations, and whether an alternative methodology demonstrably lessens that bias.

- whether the AER has modelled the impact on consumer prices of (i) changing its methodology for estimating inflationary expectations, and (ii) any shift towards a hybrid approach. We consider 'back-casting' to be the most effective way for assessing the impact of these changes for consumers. This involves comparing a baseline of the AER's past regulatory decisions against how they would hypothetically have differed in light of (i) and (ii).

- whether the AER commits to deferring a final decision on the regulatory treatment of inflation so any changes are considered in conjunction with potential changes to the rate of return instrument.

- if the AER countenances a change to the regulatory treatment of inflation when doing so will clearly favour the networks, the CRG expects the AER to identify an approach to sharing with consumers any resultant short-term benefits that would otherwise accrue in their entirety to the networks.

To be clear, the CRG holds no *a priori* commitment to the real rate of return approach currently applied by the AER. This approach has its flaws; perhaps most notably, it requires the AER to estimate inflationary expectations although there is no verifiably correct way of doing so. Ben-David's submission to AER's inflation discussion paper of 29 July 2020 proposed an approach to overcome this problem. In the absence of such a solution, the CRG considers any change to the real rate of return approach must be part of a package of reforms that can be fully tested against the long-term interests of consumers.

Yours sincerely,

Craig Memery
Chair
Consumer Reference Group