MEMORANDUM

Date 20 November 2020

To AER Board

AER Review of regulatory treatment of inflation

Follow-up to 16 November AER Board presentation

This memorandum follows up a number of critical points of discussion, and indicated interest in receiving further information, around some specific issues that arise from Energy Networks Australia's recent presentation to the Board of the Australian Energy Regulator on the October 2020 Draft Position Paper *Review of Regulatory treatment of inflation*.

1. Availability and scope for networks to issue inflation-indexed bonds

In the context of discussions on underlying drivers of the hybrid model, the issue was raised of the potential for energy networks to access inflation indexed debt as an alternative mechanism to manage these risks. The AER Board indicated a specific interest in ENA providing further information on the size and scope of inflation-indexed bond markets.

A significant issue in this regard is the limited size and liquidity of the relevant market. Corporate bond market information is available from Bloomberg.

A search on 16/11/2020 produced the following information in relation to bonds issued by Australian corporates:[1]

	All corporates	Inflation - indexed
Number of bonds	2,834	43
Total principal ($ billions)	920.0	4.6
Average principal ($ millions)	339.0	106.0

The AER's most recent *State of the Energy Market* report indicates that the total RAB of electricity networks and gas pipelines regulated by the AER is approximately $112 billion,[2] with total debt financing requirements of approximately $67 billion. This is almost 15 times the entire value of Australian inflation-indexed debt on issue.

To summarise this information:

[1] Using the fixed income SRCH function, selecting Corporate bonds, Active bonds, setting country of risk to Australia, and then selecting inflation-linked securities.
[2] See Figures 3.17 and 5.8.

Energy Networks Australia www.energynetworks.com.au
Unit 5, Level 12, 385 Bourke Street Melbourne VIC 3000
P: +61 3 9103 0400 E: info@energynetworks.com.au
Energy Networks Association T/A Energy Networks Australia
ABN: 75 106 735 406

- There are relatively few inflation-indexed bonds issued by Australian corporates (i.e., they constitute around 1.5% of instruments on issue).
- The entire principal raised from inflation-indexed bonds (representing less than 0.5% of the market by principal value) is less than the debt portfolios of most individual networks.
- The only inflation-indexed bond issued by a network business is a $220 million bond issued by Australian Gas Infrastructure Group.

It is important to note that inflation-linked bonds issued by Australian corporates have payoffs that depend upon Australian inflation outcomes. There are few international lenders who are attracted by products that depend upon Australian inflation outcomes, limiting the likely scope or market expansion. Anecdotal evidence is available from a number of ENA member firms who have investigated the issuance of inflation-indexed debt and rejected that approach on the basis of cost and availability. A systematic documentation of those investigations could be collated and provided to the AER if that would be useful.

2. Consensus Economics forecasts

There was a discussion comparing the current forecasts of the Consensus Economics survey (a 2.3% figure was mentioned), with the AER's Draft Position (1.95%).

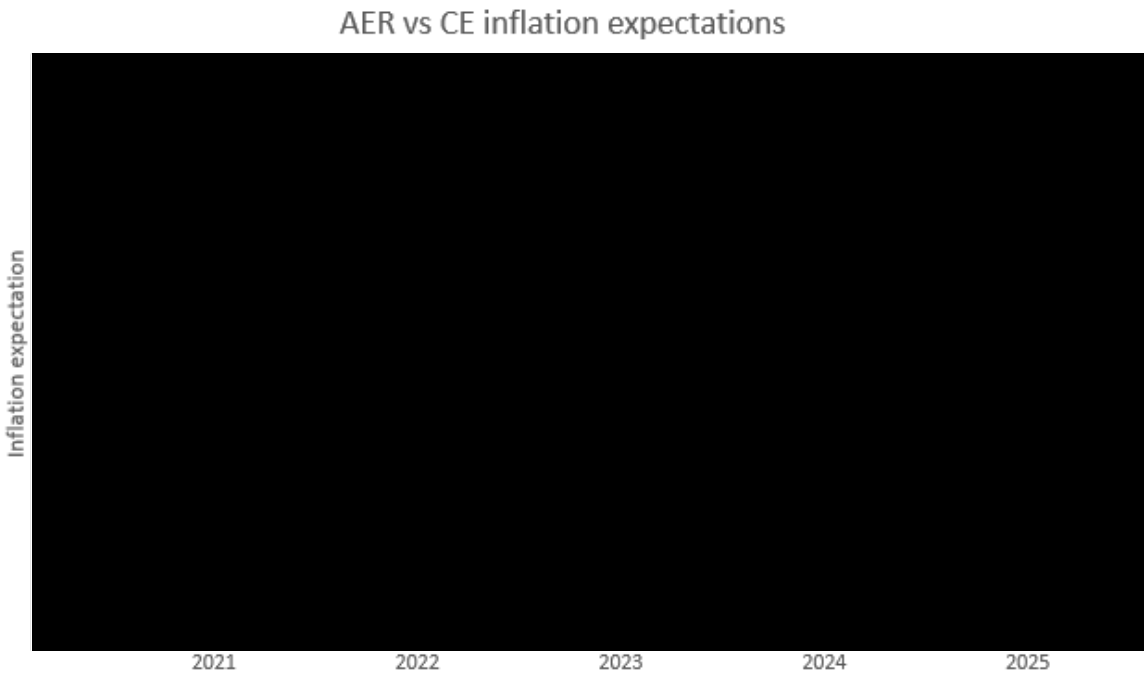
This note highlights the relevant comparisons to make between the AER Draft Position and Consensus Economics forecasts.

The relevant points of comparison are shown in the table below.

	5-year geometric mean	10-year geometric mean
AER Draft Position	1.95%	2.22%
Consensus Economics	[redacted]	[redacted]

The most recent set of Consensus Economics (CE) long-term forecasts[3] are compared with the current AER forecasts[4] in the figure below.

[3] Available in the Consensus Economics report in October 2020.
[4] Using the June figures in the RBA's SMP from November 2020.



For any 5-year regulatory period, if the AER forecast is above the best estimate of inflation, networks will be under-compensated over that regulatory period, and vice versa in the reverse situation.

Compensation in the subsequent regulatory period

This then raises the question of whether networks might expect to be over-compensated in the subsequent regulatory period – from years 6-10. In particular, the CE forecast over years 1-10 is [redacted],[5] which is higher than the forecast over years 1-5, that being [redacted]. That is, the CE respondents generally expect inflation to higher in years 6-10 than in years 1-5.

But there is no basis for any expectation of any "catch-up" of under-compensation from the first regulatory period. This is because the AER automatically re-sets its inflation allowance afresh in the subsequent regulatory period, through the next determination.

That is, the only relevant comparison is between the market's expectation for inflation over a regulatory period and the AER's inflation figure. If the AER's figure is above the market's expectation, the AER will 'take out' more than the market expects to be 'put back' and networks will be under-compensated. And vice versa in the reverse case.

Thus, the current CE figures for years 6-10 are only relevant if they inform us about whether the AER's figure is likely to be above or below the market's expectation at the time of the next determination, five years from now. But it is difficult to see how today's CE forecasts for 6 to 10 years in the future would provide any guidance about

[5] Geometric average.

the extent to which the AER's forecast might be above or below market expectations when those things are re-set at a point in time five years hence.

Do the Consensus Economics forecasts reflect investor expectations?

ENA does not consider that it is valid to interpret the CE survey responses as reflecting investor expectations of future inflation. The CE data is based on participants completing a form where there is no economic cost to a participant providing estimates that turn out to be inaccurate.

By contrast, the market estimates from the breakeven and swaps methods are derived from the prices of traded securities – where investors have real money at stake. Those approaches currently produce materially lower forecasts of future inflation, as documented in the ENA submission.