Review of AER's approach to inflation

Network sector response to AER Draft Position Paper

AER Inflation Review Public Forum

21 October 2020

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Networks’ high-level response to the Draft Position Paper

» Appreciate that the proposed change is a significant step toward bringing regulatory inflation estimates towards the best estimate of future inflation.

» The new approach should be immediately implemented.

» Seek to better understand the AER’s reasoning in some areas.

» Seek to better understand consumer views on some issues.

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Estimation

- A step in the right direction.
- Concerns about the (pivotal) RBA estimate for Year 2 inflation.

Key conclusions from the Draft Position Paper

- **5-year estimate**: The new approach matches the deduction to allowed revenues to the expected benefit of RAB indexation:

  *We consider that adopting an inflation term that is the same length as the relevant regulatory period (typically, 5 years) would, in expectation match RAB indexation over the regulatory period. This is desirable because service providers will in expectation receive **the same allowance during RAB indexation in the RFM as the amount (expected inflation) deducted from total revenue in the PTRM**. Thus, service providers are expected to receive the nominal return set in the rate of return instrument over the regulatory period.*

  Draft Position Paper, p. 48.

- **Introduction of glidepath**: The glidepath better reflects the time taken for expected inflation to return to the RBA mid-point:

  We are also persuaded that applying a glide-path is likely to result in a better estimate of expected inflation if short-term market conditions impact the time it will take for expected inflation to revert to the RBA's mid-point.

  Draft Position Paper, p. 62.

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Move to a 5-year estimate

Why move from 10 years to 5?

- The deduction from allowed revenues in the PTRM should equal (at least in expectation) what is added back via RAB indexation in the RFM. [Lally]
- What is added back in the RFM is 5-year inflation.
- So what is deducted in the PTRM should also be 5-year inflation.
- **The term for inflation is determined by the RFM, not the Rate of Return Instrument**

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AER framework – take out what you expect to put back in

Figure 4 Mismatch between 10 year expected inflation and 5 year RAB indexation over period.

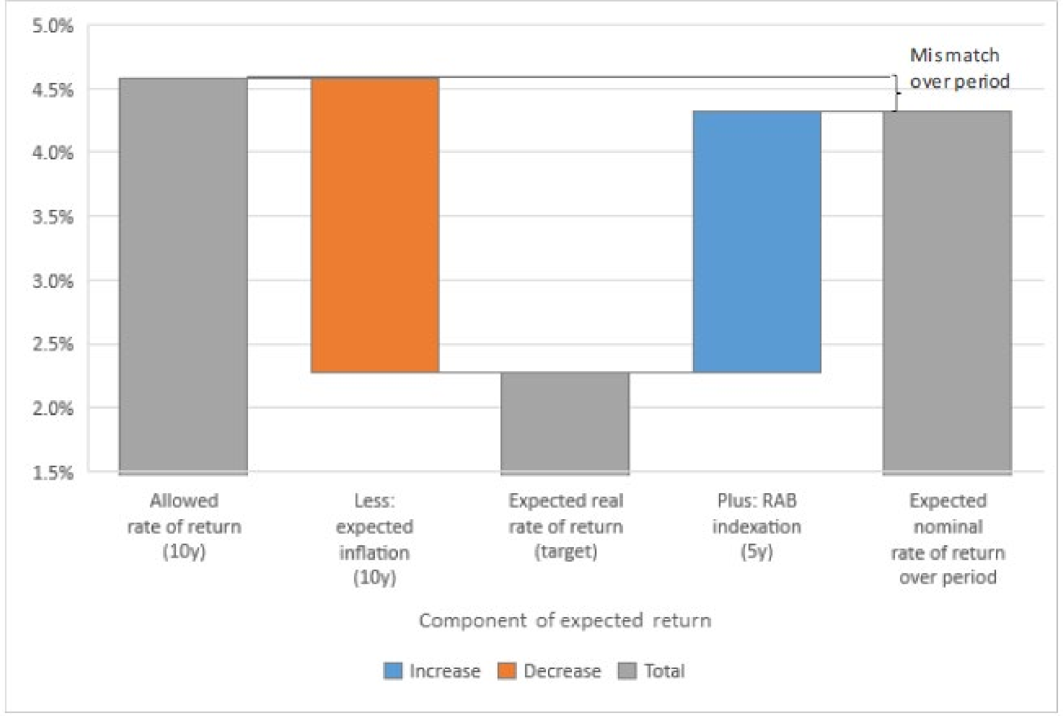
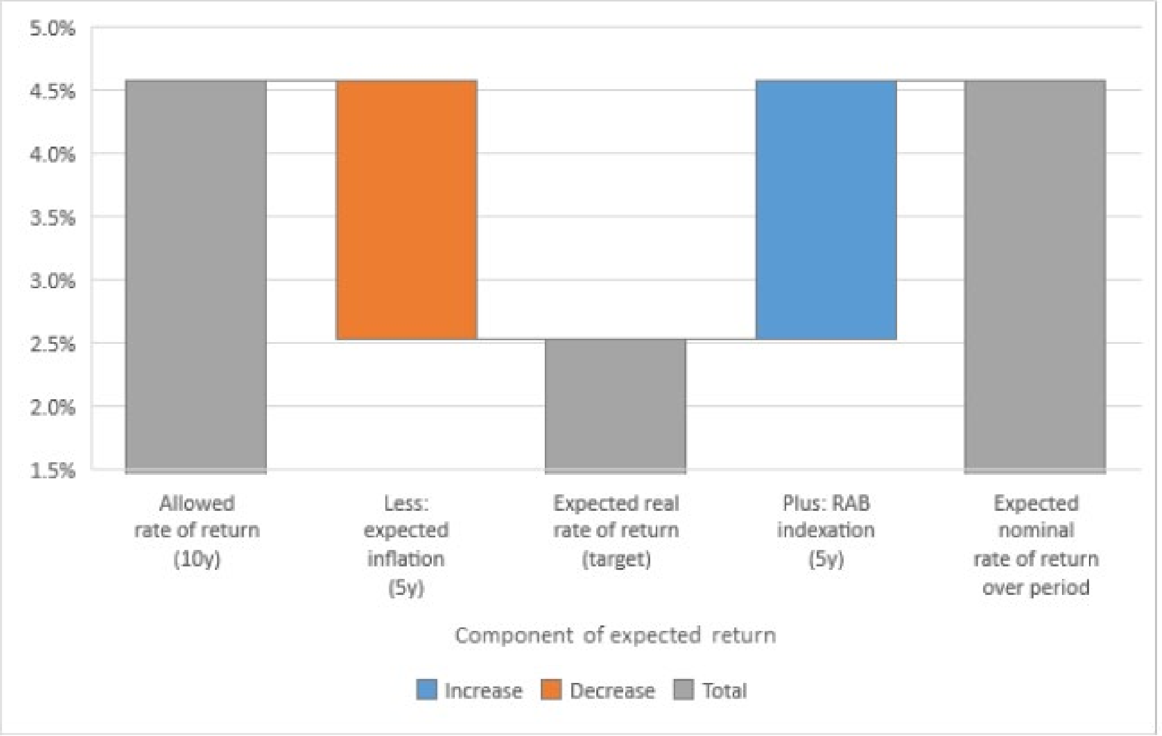
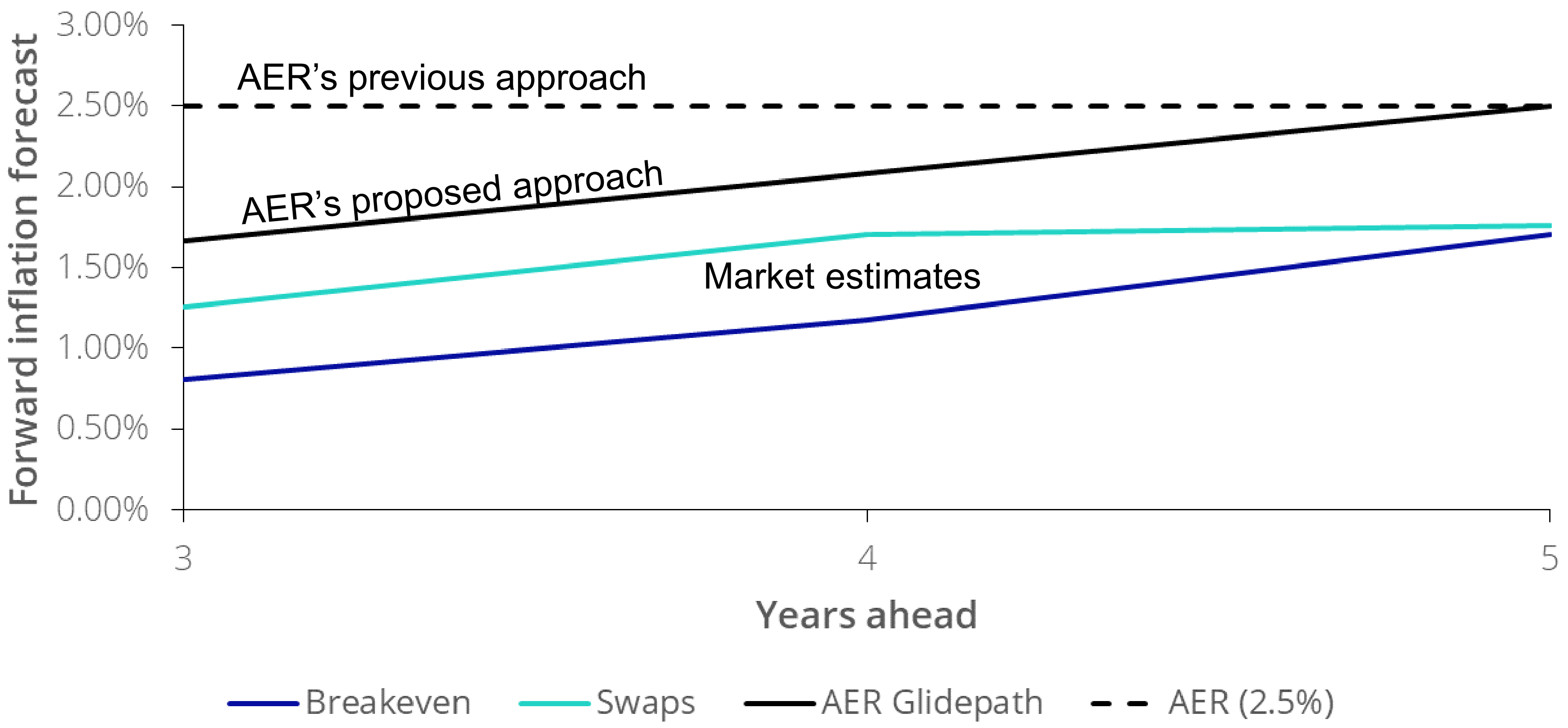


Figure 5 Matching expected inflation term with regulatory period



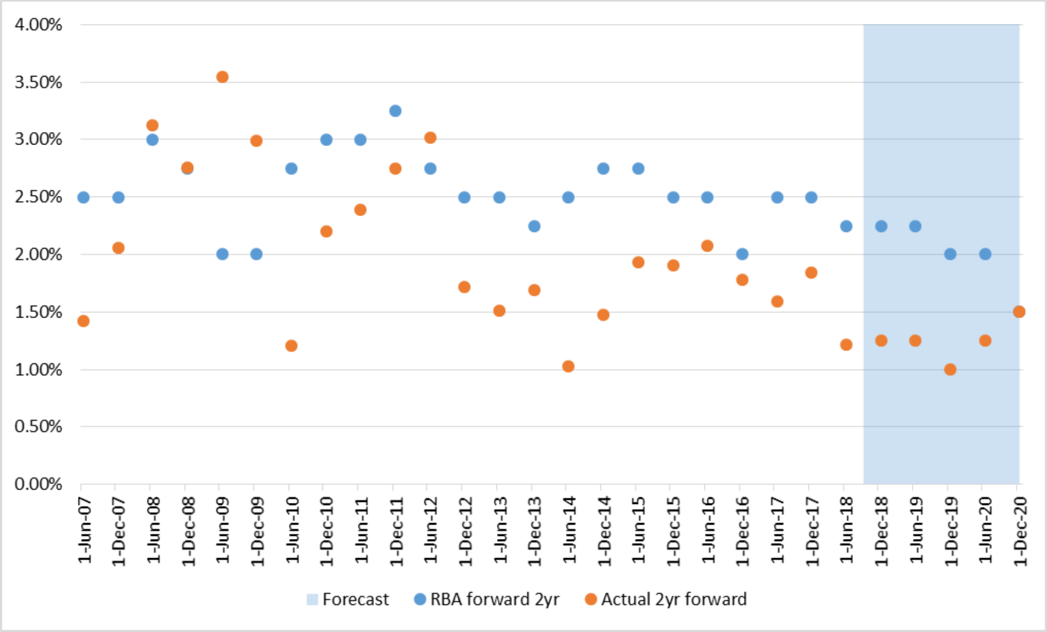
Source: AER Draft Position Paper.

Glidepath: A step in the right direction

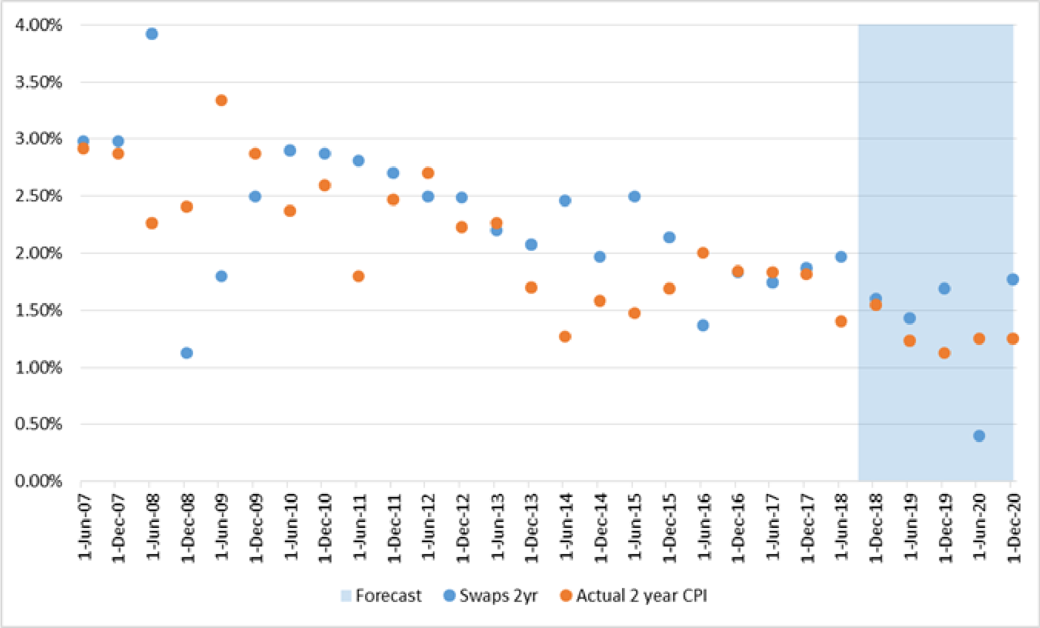


Concerns remain about the (pivotal) RBA Year 2 estimate over-forecasting in low-inflation environments

RBA 2nd year forecast vs actual inflation for that year



Swaps 2nd year forecast vs actual inflation for that year



» While networks recognise that the new approach is more in line with market expectations, based on historical data, it is still likely to overstate inflation – particularly in low-inflation environments.

Transition

- No rationale for any transition.
- Why prolong the use of an inferior estimate?
- An ideal time to move to a better approach.

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Key conclusions from the Draft Position Paper

- A better approach is available:

> *Our draft position is that there is likely to be a **better approach** to estimating expected inflation **than the one we currently use**. This better approach is likely to incorporate a glide-path and a term profile that matches our escalation of the RAB.*
>
> Draft Position Paper, p. 87.

- The new approach produces the best estimate that best promotes the NEO/NGO:

> *Our draft position is that, a term that matches the length of the regulatory period together with a glide-path as outlined above, will provide a method likely to result in the **best estimate of expected inflation**, and therefore **achieves the NEO/NGO to the greatest degree**.*
>
> Draft Position Paper, p. 62.

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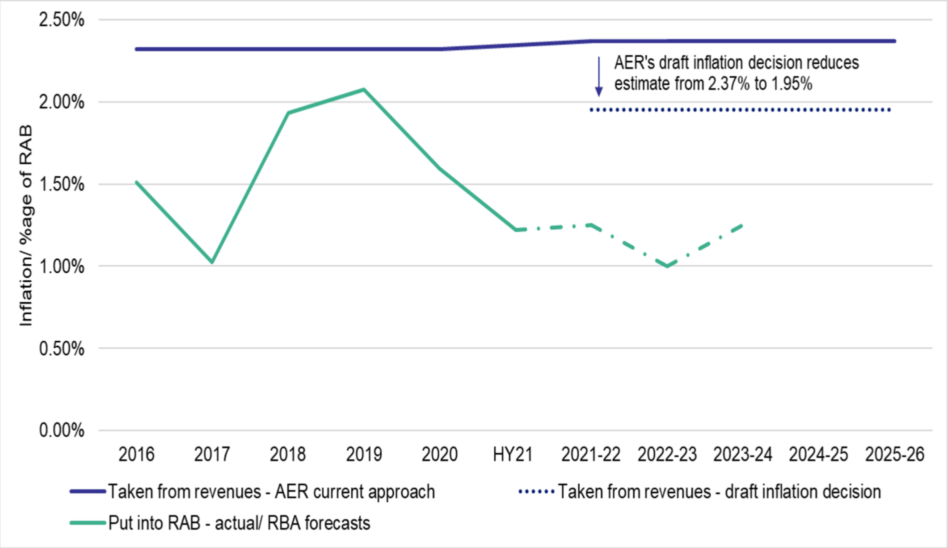
There is no rationale for a delay in implementing the best estimate

- **It is not a ‘windfall gain’ to adopt the AER’s best estimate.**
- Transitions are not used when updating parameter estimates. Only used for what the Draft Position Paper calls ‘framework changes’ such as trailing average return on debt.

- **In any event, where is the windfall gain here?**



Sources – 2016-20 PTRMs and RFMs, RBA Statement of Monetary Policy Aug 2020 – year-ended Dec 2020- 2022 CPI forecasts.

- Allowed returns (and prices) are materially lower because we are stuck in an environment with historically low interest rates and low inflation.
- **An inconsistency and bias would be introduced by:**
  - **Lowering allowed returns to reflect the current extraordinary low interest rate / low inflation environment; while**
  - **Continuing to use a high inflation estimate**.

- **No basis for waiting until the new approach produces an estimate of 2.5%**
  - May take many years.
  - Why prolong the very problem we are trying to fix?

- **No basis for waiting until the RoRI**
  - Term of inflation estimate is determined by RFM not RoRI.

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We should use the new approach immediately

The new approach produces the best estimate of expected inflation that best promotes the NEO/NGO.

There is no reason to maintain an inferior estimate. That would simply prolong using an approach that does not best promote the NEO/NGO.

No windfall gain if immediate change is made.

The new approach is NPV=0 and most consistent with the NEO/NGO. No windfall gain, just setting the regulatory allowance to the efficient level.

When revising parameter estimates, the usual approach is to adopt the new estimate immediately.

Using the best available estimate best promotes the NEO/NGO.
Should transitions be used every time a parameter estimate is changed?

Very different from trailing average approach to return on debt.

Transition was designed to mimic the efficient cost that would be borne by a network transitioning from the rate-on-the-day approach to the trailing average approach.
No change in any assumption about efficient network practice here.

The rationale for the hybrid approach

- Networks seek to better understand the AER’s reasoning, and consumer perspectives, in relation to the hybrid approach.

A recap of ENA’s submission

Proposed approach

- For the debt component of the RAB, index using the AER’s estimate of expected inflation rather than actual inflation.
- This creates no price shocks because it maintains RAB indexation.
- This approach has no long-term impact on average prices or volatility. ENA has demonstrated this, at the request of the AER, using the AER’s simulation model.

Rationale for this approach

- The NEO/NGO is best promoted by setting the regulatory allowance equal to the benchmark efficient financing cost.
- The benchmark efficient approach to debt is to issue 10-year nominal debt on a staggered maturity basis.
- The proposed approach to RAB indexation ensures that the regulatory allowance matches the benchmark efficient cost of debt.

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Further engagement to clarify views

» ENA continues to believe that the hybrid approach has some attractive features for consumers and the NEO/NGO:
  – Zero price impact for consumers over the next 5 years.
  – Zero impact on long-term average prices or volatility.
  – Automatic stabiliser for future scenarios in which actual inflation differs materially from AER forecast.
  – Ensures that allowed return matches the efficient cost of providing the service in each regulatory period.

» ENA is interested in better understanding consumer perspectives on this issue.

» ENA also seeks to better understand the AER's reasoning on this point:
  – Should the allowed return match the efficient cost in each regulatory period? Isn't that the best way of ensuring NPV=0?
  – Appears to be an inconsistency whereby AER uses:
    » Nominal debt benchmark for return on debt parameter; and
    » Real debt benchmark for inflation parameter.

The importance of the negative NPAT issue

- Networks seek to better understand the AER's reasoning in relation to negative allowed NPAT.

Negative NPAT is a real issue for networks

- Networks seek to better understand the AER's reasoning in relation to negative NPAT:
  - Sapere identified that negative NPAT indicates an underlying inconsistency that is inconsistent with the efficient functioning of a network.
  - ENA's submission explains why that point is not addressed by pointing to expected increases in RAB.
  - For example, any business that records negative NPAT for 10 straight years (two reg. determinations) will have issues maintaining credit ratings and attracting investment – regardless of expectations about future appreciation in asset values.
  - Remember, this is for the benchmark firm, so unregulated revenues, other income, and incentive payments are not relevant here.

- The reference to Google/Alphabet is not relevant:
  - Google had NPAT of USD +$34.3 billion in 2019.
  - The point is not that the benchmark firm is unable to pay dividends under the current allowance, but rather that an equity injection is required each year for the benchmark efficient firm.

- Networks encourage the AER to perform the investigation into this issue that Sapere has advocated.

Summary of network proposals and draft outcomes

Changes proposed by networks	AER Draft Position	Network reactions
Use 5-year horizon to match period of RAB indexation.	✓	• Agree that the deduction to allowed revenues in the PTRM should match the expected benefit of RAB indexation in the RFM.
Have regard to estimates from market data.	✗	• Networks agree that glide-path is more realistic than previous approach. • Disappointed that market data continues to play no direct role. • Maintain concerns about RBA forecasts in low-inflation conditions.
Adopt hybrid approach to reflect efficient issuance of nominal debt.	✗	• Seeking to better understand rationale for AER's rejection. • Seeking to better understand consumer views on this point.
Comprehensive analysis of negative NPAT issue.	✗	• Draft Position Paper focuses on other issues. • Other opportunities to fully consider this important issue as part of RoRI process.

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