

INTRODUCTION

The Energy Users Association of Australia (EUAA) is the peak body representing Australian commercial and industrial energy users. Our membership covers a broad cross section of the Australian economy including significant retail, manufacturing, food and materials processing industries. Combined our members employ over 1 million Australians, pay billions in energy bills every year and expect to see all parts of the energy supply chain making their contribution to the National Electricity Objective.

Our members are highly exposed to movements in both gas and electricity prices and have been under increasing stress due to escalating energy costs. These increased costs are either absorbed by the business, making it more difficult to maintain existing levels of employment or passed through to consumers in the form of increases in the prices paid for many everyday items.

This submission begins with some general comments including discussions with the Consumer Reference Group. It then responds to the specific questions asked by the AER in its Discussion Paper.

On the basis of the evidence presented so far, we see no reason to change from our position of support for the AER's Final Decision in the 2017 review¹ that retained the current AER methodology to measure expected inflation. Further, we see a review of expected inflation as the wrong forum to decide whether there should be a move away from the current real return framework. That question is one that better sits as part of the forthcoming review of the rate of return binding guideline where it can be considered in the context of the overall risk allocation between networks and consumers.

While some flexibility is important for exceptional circumstances, good regulatory practice is built on consistency and predictability. Both investors and consumers place a high value on these system attributes. This starting point is that there must be a very good reason for change such that the "bar" for change should be set relatively high to ensure that any change is enduring and unambiguously in the long-term interests of consumers. We also need to ensure that the transactions costs of the change do not swamp the proposed benefits and so that if unexpected adverse impact occurs in the future, there are still net benefits. It is worth remembering that the current approach came about in 2008 because of a network's dissatisfaction with the previous bond breakeven approach.

During our discussions with the Consumer Reference Group we were asked for our views on the importance of price stability in the context of different approaches to expected inflation. The AER has traditionally placed considerable importance on price stability in its approved price paths for network revenue resets. We made the following comments to the CRG:

- (i) It would help to have some specific data on the impact of changing the expected inflation methodology e.g. what would the allowed revenue/price reductions have been from 1 July 2020 for Energy Queensland and SAPN were the bond break-even approach been used?
- (ii) Our members already face significant price variations in their delivered electricity price e.g. RERT, FCAS, hedge costs and environmental program costs that are likely to be a considerable magnitude higher than the adjustments the AER makes in network prices to achieve price stability. In the absence of specific information on (i), it is difficult for them to say whether they support a particular approach because it results in 'price stability'.

¹ AER "[Regulatory Treatment of Inflation Final Position](#)" December 2017

RESPONSES TO SPECIFIC QUESTIONS

1. *What are the available indicators of expected inflation and what are their strengths and weaknesses?*
2. *Should we continue to use our current approach to estimating expected inflation?*

We believe that the AER’s reasoning described in detail in its December 2017 Final Decision to continue using the current approach, still applies. No method is perfect, but on the basis of the evaluation criteria (congruence, robustness, transparency replicability and simplicity), we agree with the AER’s conclusion:

“...our current approach has the greatest strengths and fewest weaknesses and therefore provides the best estimate of expected inflation.”

This conclusion is supported by the Deloitte analysis prepared for the current review that concluded that the current approach was still “fit for purpose”².

It seems that the arguments for change focus on the last 5-7 years and expectations around the next 5 years. We understand that for the 10-15 years prior to ~2015, the periods when the measure of expected inflation was above actual inflation more or less balanced out with the periods when the opposite occurred. It would be good to have that data available to inform the current debate. Consumers have accepted a regulatory contract that ‘over time’ we accept demand risk and pay an efficient price and network equity investors will receive a real rate of return that reflects the risk they bear. Business cycles come and go in the long life of network investments.

As an aside, we agree with the AER’s reasoning in its 2017 Final Decision to support the use of CPI³:

“...the CPI is the most suitable method for measuring inflation due to its simplicity, relative timeliness and high degree of credibility and familiarity.”

Use of the trimmed mean in the recent Energy Queensland and SPAN decisions was a temporary measure and we do not consider it relevant to the current discussion.

3. *Are there improvements we could make to our current approach to estimating expected inflation?*
 - i. *For example, should we consider a glide path approach? If so, explain why we should consider it and how the approach would be implemented — linearly or non-linearly, time horizon?*
 - ii. *For example, should we use a different measure of inflation rather than the headline Consumer Price Index or CPI? If so, explain why we should consider an alternative measure and its advantages.*

We recognise that there is a risk that a post COVID recession may lead to inflation expectations delinking from the RBA target range – it may take longer than ‘normal’ for the expectations to revert to the RBA’s mid-point. Given this we are prepared to consider a glide path approach. The CCP’s submission to the 2017 review⁴ suggested consideration of a glide path would include analysis of:

- (i) Definition of a relevant event – this would be a rare event e.g. a statistical test such as 2 standard deviations from the observed historical mean
- (ii) The trajectory of the glide path – we tend to favour a linear approach with the time path influenced by the size of the difference between the RBA’s forecast in year 2 and 2.5%; any adjustment would be symmetrical for when the forecast rate in year 2 is much higher than 2.5%.

² Deloitte “[Review of the Regulatory Treatment of Inflation](#)” June 2020p.8

³ Ibid p. 18

⁴ [CCP Submission](#) on AER Preliminary Position pp13-15

A lot more analysis is required to work out the details.

4. *Should we use an alternative approach to estimating expected inflation? If so, set out the alternative approach and its advantages over our current approach?*

No. We support the current approach.

5. *Does our current approach deliver the target ex-ante expected real rate of return?*

Firstly, we agree with the AER’s interpretation of the rules in its 2017 review that targeting the real rate of return is consistent with the rules. Secondly, we agree with the conclusion of the 2017 review that the regulatory framework does deliver the ex-ante real rate of return over the long term apart from a first-year pricing effect that was minor and symmetrical. This outcome is independent of whether the outturn inflation is above or below the forecast of expected inflation.

Concerns expressed that this is not the case were reviewed by the AER in 2017 and found wanting⁵. Perceived problems identified in some network submissions were more correctly identified as⁶:

“...intended features, because these features act to deliver the initial real rate of return (and not, for example, the initial nominal rate of return).

The Sapere report⁷ prepared for this current review affirmed the AER’s 2017 conclusion.

6. *Should we switch to a nominal or hybrid approach to setting NSP revenues? If so,*

i. How should this mechanism be implemented?

ii. Why is it superior to our current approach?

iii. Are investors in NSPs prepared to take on the risk of unexpected movements in inflation?

iv. Is there a need for transitional arrangements?

We note the concern of networks that the current approach may result in very low or negative returns to equity holders and they are effectively the ‘swing’ for the difference between actual and forecast expected inflation after debt holders are paid. As the AER concluded in 2017, the framework targets a real return on capital not a real return on equity. Networks are best placed to bear their financing risk. For example, some choose to have a level of leverage higher than the 60/40 benchmark entity which increases their risk of lower equity returns under the current expected inflation methodology.

We await further evidence from the networks on the impact of low equity returns on investment levels and the long-term interests of consumers. Currently networks seem to be arguing two related points:

- That a low or negative return on equity will result in capex that is less than the benchmark efficient level. If that were the case then we would expect to see the AER approved level of capex being higher than that proposed by networks. However, that has not been the case in any network decision since 2017⁸.

⁵ See the discussion in Chapter 6 in the December 2017 Final Decision

⁶ Ibid p. 74

⁷ Sapere [“Target Return and Inflation”](#) June 2020

⁸ Five networks had their final proposal capex reduced, the AER accepted four networks’ final proposal capex and one network accepted the AER’s draft decision capex.

- This lack of investment presents an intergenerational equity issue. We do not find arguments suggesting intergenerational equity issues support higher equity returns. First, historically future generations have been richer than previous generations so will have a greater capacity to pay. Second, this argument assumes that investment now is always no regrets. For example, uncertainties around the impact of technological change on distributed generation may well mean it was the appropriate decision to not invest now as it avoids an increase in a future generation's stranded asset risk.

Nevertheless, we look forward to the network submissions on this Discussion Paper to better understand their concerns. We have a joint objective of ensuring the long-term efficiency of the regulatory framework in delivering the national electricity and gas objectives.

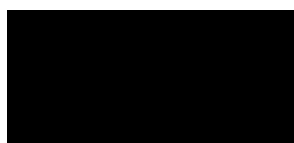
It would be very helpful to the current discussion if the AER profitability data were available prior to the end of this review. The AER's Final Position Paper last December⁹ indicated that information requests would be sent out in February 2020, but no timetable was given on when the results would be published.

Finally, and most importantly, we do not consider a review of expected inflation to be the appropriate forum to consider such a profound change in the regulatory framework that would be involved in adopting the hybrid approach. Given a nominal debt approach moves risk to consumers, they should be rewarded with lower prices but this can only be considered by our members in the context of the overall risk allocation between consumers and networks. The appropriate place for that discussion is the forthcoming review of the binding rate of return guideline.

7. *What is the best approach to incorporate inflation expectations into the trailing average return on debt? Explain why you consider your approach is the best approach.*

We await other submissions on this matter to help inform our view. Please contact me if you would like to discuss this submission further.

Sincerely,



Andrew Richards
Chief Executive Officer

⁹ [AER "Final Position Paper Profitability Measures for Electricity and Gas Network Businesses" December 2019](#)