12 November 2020

Warwick Anderson
General Manager
Australian Energy Regulator
GPO Box 520
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Email: InflationReview2020@aer.gov.au

Dear Warwick

REVIEW OF THE REGULATORY TREATMENT OF INFLATION DRAFT POSITION

Energy Queensland Limited (Energy Queensland) appreciates the opportunity to comment on the Australian Energy Regulator's (AER's) draft position on the review of the regulatory treatment of inflation.

In its draft position, the AER is proposing to move from its current approach to estimating expected inflation. The AER's current approach estimates expected inflation as a 10-year geometric average of the Reserve Bank of Australia's (RBA's) short term forecasts (for the first two regulatory years) and the mid-point of the RBA's target band (2.5 percent) for years 3 to 10. The AER is proposing to:

- Adopt a 5 year term that matches the length of the regulatory period.
- Apply a linear glide-path from the RBA's forecasts of inflation for years 1 and 2 to the mid-point of the inflation target band (2.5 per cent) in year 5.

Energy Queensland considers that the AER's draft position represents a welcome step towards improving the estimation of expected inflation. We endorse the adoption of a 5-year glidepath approach.

While the draft position improves on the AER's current approach, we are concerned that the 5-year glidepath, as proposed by the AER, is unlikely to result in the best estimate of expected inflation as required by the National Electricity Rules (Rules). We have two key concerns. Firstly, inflation reverting to the mid-point by year 5 is unrealistic in the current low inflation environment, where inflation outcomes have consistently been below the lower bound of the RBA's target band. Secondly, we consider that the RBA has consistently over-forecast inflation in year 2. Energy Queensland's view is that the proposed 5-year glidepath can be significantly improved by placing some weight on market-based estimates. For example, market based estimates could be used to inform the year 5 estimate used in the glidepath.

Lastly, we consider that the 5-year glidepath approach should be adopted without any transition. The AER should not persist with an approach that does not result in the best estimation of expected inflation, as required by the Rules. Adopting the new approach does not give rise to any windfall gain issues. In fact, the new method only serves to reduce the losses that network businesses have been incurring under the AER's current approach.

Should you wish to discuss any aspect of this matter further, please contact Guy Mutasa on [redacted].

Yours sincerely

[redacted]

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Manager Regulation

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