Ref: 20201104CG:CB

6 November 2020

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Mr Anderson

Draft Position Paper – Regulatory Treatment of Inflation

Essential Energy welcomes the opportunity to provide feedback to the Australian Energy Regulator ("AER") on its draft position paper ("the paper") on the regulatory treatment of inflation. Energy Networks Australia ("ENA") has also made a submission in relation to this issue, of which we are supportive.

Essential Energy appreciates the AER's recognition that the current approach to estimating inflation could be materially improved by shortening the estimation period to five years. Moreover, the application of a linear glide path approach from the RBA's forecasts of inflation for years one and two, to the mid-point of the inflation target band (2.5 per cent) in year five, is a sensible approach. As noted in the paper, data from the RBA indicates that it is likely to take more time for inflation to return to the RBA's target band than previously envisaged.

Essential Energy supports an immediate implementation of the proposed changes. A transition is not considered necessary, given there is no requirement for networks to adjust operationally (unlike the transition to the trailing average cost of debt). This immediate change also aligns with the implementation of parameter changes in the Rate of Return Instrument. Essential Energy encourages further engagement by the AER with consumers, to demonstrate the logic and benefits of the proposed changes.

Shortening the target inflation period

The AER's proposal to shorten the target inflation period from ten years to a shorter period that matches the regulatory period (typically five years) is supported by Essential Energy as it is likely to result in a better estimate of expected inflation. The longer the period, the more difficult it is to forecast potential inflation rate movements and this is particularly pronounced in the current turbulent economic period that is being experienced both in Australia and globally.

In the latest Statement from the RBA Board in August 2020, it was noted that inflation is expected to average between 1 and 1.5 per cent over the next couple of years[1]. A shorter target inflation period will result in an estimate that is more reflective of current market conditions. Essential Energy does not believe that it is necessary to defer the introduction of a shorter period or phase it in gradually, given the benefits of doing so, as outlined in the paper.

[1] Statement by Philip Lowe, Governor: Monetary Policy Decision https://www.rba.gov.au/media-releases/2020/mr-20-18.html

Introducing a linear glide path

The paper proposes applying a linear glide path approach from the RBA's forecasts of inflation for years one and two, to the mid-point of the inflation target band (2.5 per cent) in year five. This represents a pragmatic, symmetrical response to reducing the variance between expected forecast inflation and actual inflation, which has been highlighted by the prevailing economic conditions. Essential Energy agrees that no transition is required for the change to a simple linear glide-path as it is not a framework change, and is aimed at achieving the best estimate of expected inflation over the regulatory period.

Potential impacts on consumer interests

The impact of the changes proposed by the AER, given current economic conditions will result in an increase in revenues recovered by network businesses, and an increase in network charges for customers. Of importance is the symmetrical nature of the proposed changes though, such that in times of higher actual inflation than forecast, customer prices will be lower than without the changes. From a timing perspective, the implementation of these changes, while rates of return are expected to be very low for some time, should provide a significant buffer to increases in network charges. It is important that there is comprehensive engagement with customers on the proposed changes to demonstrate the rationale and benefits of implementing them.

In conclusion, the AER's proposed enhancements to the regulatory treatment of inflation are welcomed by Essential Energy and should help advance the national electricity objective of promoting efficient investment in, and efficient operation and use of, electricity services for the long-term interests of consumers of electricity. Essential Energy welcomes the opportunity to discuss these issues further. Please contact our Head of Regulatory Affairs, Natalie Lindsay on [redacted] or [redacted].

Yours sincerely

[redacted]

Chantelle Bramley
General Manager Strategy, Regulation and Corporate Affairs