

Warwick Anderson
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Australian Energy Regulator
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By email: rateofreturn@aer.gov.au

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Dear Warwick

Response to AER's Preliminary Position Paper on Regulatory Treatment of Inflation

Jemena Electricity Networks (Vic) Ltd (**JEN**) welcomes opportunity to comment on the Australian Energy Regulator's (**AER**) Preliminary Position Paper (**position paper**) on the regulatory treatment of inflation. We also appreciate the AER for holding several workshops to engage on the issue from the various stakeholders' perspectives. In particular we would acknowledge the analysis and feedback provided by the Customer Challenge Panel (**CCP**).

The AER explored two issues in relation to regulatory treatment of inflation – the estimation method for forecasting inflation expectations and the regulatory treatment of inflation.

On the regulatory treatment of inflation Jemena recommended a post regulatory period true-up for outturn inflation to take away the inflation risk from the regulatory framework without any true-up for the current regulatory period so that the change is neutral to all stakeholders. However, given the feedback from consumer representatives on inflation risk not being material and not warranting any change to the existing framework we do not wish to pursue this issue any further.

In the below sections we only discuss the issue in relation to glide path estimation method for forecasting inflation expectations -

Review of the position paper

The reasons in the position paper on rejecting the glide path method are extremely hard to follow. For instance the paper uses extracts from Tulip and Wallace (2012) paper, which has no reference to glide path, to conclude that there is rapid reversion of headline inflation to the mean in Australian context and that a glide path maybe unnecessary. Also contrary to this finding the position paper reports that as per the RBA's document, The Transmission of Monetary Policy, *'In Australia, transmission of monetary policy occurs at a lag but is typically shown to be one to two years'*. There is no attempt to reconcile these seemingly different conclusions.

A further analysis is done to show congruency with actual inflation expectations which is assumed to be 2.5%. We do not understand how this analysis is useful in comparing

a glide path to AER's current approach as the analysis defines volatility as estimate differing from 2.5%. Infact, as per this analysis simple choosing 2.5% inflation forecast would result in least volatility – but then is it best forecast to use?

We are concerned that despite consumers and industry acknowledging benefits from glide path approach, it may be rejected without being properly considered in the position paper.

We appreciate AER's concern around policy changes that may impact inflation forecasts. Any such, for example introduction of carbon tax or changes to GST, etc need to be carefully considered when deciding the best forecast approach. However, we understand that normally such policy changes are announced well ahead of the time from when they are implemented which provides the Reserve Bank sufficient time to forecast their impact on inflation. For example, in New Zealand, the Reserve Bank estimated that the increase in GST scheduled to occur in October 2010 would translate to a 2.02% increase in CPI. The Commerce Commission of New Zealand made amends using this information for its purposes and continued to apply its glide path approach.¹

Jemena's recommendation

Keeping in mind the feedback from CCP around transparency and predictability of approach we recommend that the length of glide path be based on the use of trend between the RBA's one-year ahead forecast and two-year ahead forecast and extrapolating out to the midpoint of the RBA target inflation range (2.5%). The AER could also enforce a maximum length if it is concerned with the use of a longer glide path.²

Please contact me on (03) 9173 8218 if you would like to discuss this letter further.

Yours sincerely

[signed]

Sandeep Kumar
Manager Regulatory Analysis and Strategy

¹ Input Methodologies (Electricity Distribution and Gas Pipeline Services, Reasons Paper, Dec 2010

² The Commerce Commission adopts a 3 year glide path.