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Regulatory Treatment of Inflation
Draft Position
AER Reference 65487

Major Energy Users Inc (MEU) is pleased to provide its thoughts on the issues raised in the AER Draft Position Paper relating to Regulatory Treatment of Inflation.

The MEU was established by very large energy using firms to represent their interests in the energy markets. With regard to all of the energy supplies they need to continue their operations and so supply to their customers, MEU members are vitally interested in four key aspects – the cost of the energy supplies, the reliability of delivery for those supplies, the quality of the delivered supplies and the long term security for the continuation of those supplies.

Many of the MEU members, being regionally based, are heavily dependent on local staff, suppliers of hardware and services, and have an obligation to represent the views of these local suppliers. With this in mind, the members of the MEU require their views to not only represent the views of large energy users, but also those interests of smaller power and gas users, and even at the residences used by their workforces that live in the regions where the members operate.

It is on this basis the MEU and its regional affiliates have been advocating in the interests of energy consumers for over 20 years and it has a high recognition as providing informed comment on energy issues from a consumer viewpoint with various regulators (ACCC, AEMO, AEMC, AER and regional regulators) and with governments.

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The MEU has previously provided its views on regulatory inflation to the AER Discussion Paper in July 2020. In that response, the MEU reflected the views made by the AER and its CCP in 2017, that the problem identified by the networks was perhaps immaterial and that over the long term the issue would "balance out". In contrast to this observation, the AER identifies in its draft position paper that, depending on the approach used, the Victorian networks might receive an additional $300 million in revenue over the next five-year regulatory period if there was a change to the current approach to setting inflation forecasts. The MEU therefore considers the issue is material and needs to be investigated.

The MEU makes the following observations:

- From the analysis provided by the AER, it is clear that the issue of inaccurate inflation forecasts might be a material issue and should be addressed. However, as noted below, there is also an important aspect that a very high bar needs to be applied to making changes to the regulatory processes as long-term consistency is fundamental to regulatory processes.

- It is also an issue that, in the past, inflation forecasts have benefitted the networks, indicating that there are "swings and roundabouts" that have occurred. The AER has opined that, over the long term, these swings and roundabouts might balance out. Some analysis by the MEU shows that since NEM commencement, there have been about as many inflation values above the mid-point of the RBA target range as there have been below, supporting this AER view of an evening out of the "pluses and minuses" over the long term. Further, this analysis indicates that there is a small bias in that inflation has averaged above the mid-point of the target range over the life of the NEM.

- The MEU notes the observations of the AER in its draft position paper (page 25):

  > "We observe that our current method was adopted in response to service provider submissions proposing to move away from market-based measures, which they stated were biased. … Numerous submissions now propose that we should again employ market-based measures in our approach."

  The AER goes on to observe that the current approach was effectively ratified in reviews it made in 2008 (for the ElectraNet decision) and again in 2017. The MEU questions why, if the approach was changed in 2007 at the request of the networks and more recently ratified. To seek a change raises the question as to the motives of the networks in seeking to change from an approach sought by them and used for over the past 12 years.

- The networks seemed to have only raised this as an issue now it appears that a change would provide them with a higher revenue. The MEU is concerned that the networks could be seen to be addressing "minor" adjustments to the rules and guidelines as an alternative to the now removed "limited merits review (LMR)" process. The removal of the LMR was to prevent the networks "gaming" the regulatory process. That the AER accepted changes made in the past to suit the networks and is now contemplating what might be considered a partial reversion at the request of the networks is quite concerning.

- The most recent review of the approach to inflation was concluded during 2017 so this decision has been in place for a very short time. It is concerning that the AER is contemplating a change after such a short time of operation of the current approach and does not reflect that constancy as well as consistency is very important in regulatory processes.

- The MEU points out that consumers have not actively sought appropriate rule or guideline changes that might rebalance some of the changes networks have sought in the past to increase their revenues and neither (as might be expected) have networks looked to addresses errors or incorrect approaches used by the AER that might benefit consumers by reducing revenues[1].

- The AER has identified that, as a change to the current approach, a glide path might be used to forecast inflation from the RBA estimate to the mid-point of the target range. What is not clear is how the AER determines at what point in time, the mid-point is likely to be reached. Implied in the AER draft position is a view that the mid-point will be reached by year 5 of a regulatory period but there is no explanation as to why the AER has reached this decision.

  Analysis of the last 10 years of historic data shows that the annual change in inflation can swing significantly and these swings reflect a standard deviation of ~60 basis points[2]. This implies that if the AER decides that a glide path is to be used, the slope of the glide path should reflect the rate of change that history shows is statistically probable, rather than assuming a fixed point in time.

It is with these thoughts in mind that the MEU proposes the following solutions, in order of its preference, as to what change might be introduced to provide implement the inflation forecast into the revenue models.

1. As the current approach to setting inflation has only been in operation for 2-3 years, more time should be allowed to assess the actuality of the “swings and roundabouts” to evaluate whether the current approach is balanced over time. The downside of this approach is that the forecast for inflation over the near term, is that it will remain low for some years before returning to the mid-point of the 2-3% target band the RBA is tasked with achieving. The MEU points out that maintaining the current approach does offset the periods where inflation

[1] For example, the AER approach to the capital expenditure sharing scheme, by being limited to a regulatory period, allows networks move capex from one period to another and receive a benefit at the expense of consumers. Similarly, the AER approach to use 10 years as the basis for setting the cost of capital provides a benefit to networks which tend to have a shorter period for accessing their debt. The MEU points out that as the cost of debt at the far end of the 10-year period is high, the long-term flow through of the 10-year trailing average benefits the networks

[2] Over 20 years the standard deviation is ~80 bp

was higher than the mid-point in previous years and where the networks benefitted.

2. The MEU has been a consistent advocate for an annual adjustment to be made from the forecast to the actual inflation when it is known. As the MEU has been proposing this solution for a number of years and it would appear that the AER does not see this option is viable. The AER has never discussed the reasons for not taking up this option, so the MEU considers that the AER should provide reasons for not using this approach

3. The use of a glide path from the last RBA forecast of inflation to a point along the 10-year period used for financial assessments explicitly reflects a view that inflation will trend slowly towards the target mid-point over time. The problem with this approach is there is no analysis to support a forecast as to when the mid-point will be reached, although the AER has proposed assuming it will be reached at the 5-year mark.

   The MEU considers that use of recent history of annual movements in inflation provides a more statistically robust approach to how long it will take to move from the RBA estimate for year 2 to reach the mid-point of the target band than for the AER to guess when it considers the mid-point will be reached. The MEU considers that using the observed standard deviation for past inflation movement changes of between 60 and 80 basis points is a preferred option to a more arbitrary setting.

The term for averaging the inflation assessment.

The AER proposes to set inflation based on averaging the inflation assessments over the regulatory period (ie 5 years) which is a change from the current approach which averages forecast inflation over the 10-year period used for calculating all of the other financial inputs used in the rate of return development. The MEU does not agree with this proposed change. It considers that there must be consistency between all elements that determine the revenue that the networks get – this means that the averaging period for forecasting inflation should be the same as the term used for all financial inputs.

The MEU observes that it was the networks in 2008 which proposed using a 10-year averaging period and the AER concurred. The AER notes (page 24) the argument used by the network's consultant that:

> "…for consistency with past regulatory practice, the inflation rate estimate term should match the term of the nominal Commonwealth Government Securities rate used in the rate of return calculation."

The MEU points out that moving to a 5-year averaging period will result in an increase in revenue for the networks, yet it was the networks that proposed a 10-year averaging period when doing so would benefit the networks. To make a change such as this reflects the issue raised above, of the AER changing the regulatory approach at the behest of networks when it benefits them, effectively implementing a return of the LMR by stealth.

Data availability.

As discussed in its earlier response, the MEU sees there are detriments for each of the other proposed approaches to forecasting inflation than using the RBA forecasts.

The MEU considers that as the RBA has a statutory responsibility to get inflation into its target range, it has a driver for being as accurate as possible in its forecasts. In contrast, some other forms of assessing future inflation are made by those who, while they might be taking a risk on being incorrect, will include in their forecasts a premium for taking this risk and so the forecast is likely to have a bias in it.

The MEU notes that the move away from using the bond break-even approach to identifying forecast inflation was at the request of the networks, so a reversion to this approach would reflect a view of the networks seeking to benefit (again!).

On this basis, the MEU considers that the RBA data for forecast inflation is most appropriate to use.

Transition.

As the first preference of the MEU is that there be no change, under this approach there would be no need for a transition

If change is to be made, while there are a number of different options available for a transition, the MEU considers that the change in approach for inflation should occur at the same time as the next rate of return instrument (RoRI) is implemented. The MEU does not consider that a new approach to inflation should be introduced separately to the RoRI, noting that the current approach to inflation was applied concurrently with the 2018 RoRI and logic would have any change introduced with the new RoRI, rather than as a separate activity.

The MEU is happy to discuss the issues further with you if needed or if you feel that any expansion on the above comments is necessary. If so, please contact the undersigned at [redacted] or [redacted]

Yours faithfully

[redacted]

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Public Officer