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Queensland Competition Authority
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Submitted via online submissions portal

Inflation Forecasting Review 2021: Draft Position Paper

17 September 2021

Dear Charles,

Aurizon Network welcomes the opportunity to respond to the Queensland Competition Authority's Draft Position Paper on Inflation Forecasting Review 2021 (**the Draft Report**) published on 23 July 2021.

On balance the Draft Report has demonstrated consideration of stakeholder submissions and has undertaken analysis of the relevant alternate inputs and methodologies. However, Aurizon Network makes further submissions in response to the Draft Report outlined below.

Pre-2010 Break Even Inflation Rates

While the QCA's position in respect of market-based measures, such as bond break-even rates, is reasonably consistent with the analysis and conclusions of other regulators, Aurizon Network does remain concerned with the proposed consideration of pre-2010 bond break even rates due to depth and liquidity concerns with the inflation indexed bond market for those periods. Consideration of these pre-2010 bond-break even inflation rates will not be representative of forward-looking inflation expectations and should therefore not be within the QCA's regulatory consideration. Aurizon Network recommends that the QCA make the necessary adjustments to its analysis to exclude bond-break even inflation data prior to 2010 or to explain the basis of their inclusion.

Real rate of return target

The Draft Report states the QCA's draft position is to maintain its existing approach of targeting a real rate of return on investments in regulated infrastructure assets.

Aurizon Network's submission to the QCA's March Issues Paper noted the Australian Energy Regulator's reasons for application of a real rate of return target but those reasons may not be applicable to coal export infrastructure:

> *In the case of users of coal export infrastructure assets, for example, while these assets also have a long economic life, they are also at risk of stranding. This can result in a different pricing profile, including the application of accelerated depreciation[1].*

The Draft Report relies primarily on maintaining the value of funds invested as the basis of the draft position and asserts that:

> *this is best achieved by providing investors with an initial real return through revenues and then compensating them for inflation by indexing the RAB with actual inflation[2].*

However, this objective is also satisfied with a nominal rate of return target. In this regard the Draft Report does not provide the economic basis of the real rate of return framework and its beneficial application to essential service infrastrucuture. A key objective of pricing of long-lived assets is the recovery of investment in those assets over time and how that recovery effects different consumers over time. For relative perpetual assets such as power and water a real rate of return target provides a relative uniform price profile where demand growth is also relatively stable (i.e. recovery is backloaded to align with future growth).

These conditions may not prevail with coal export infrastructure and the return of capital which matches demand over the life of the asset may be best addressed through a nominal rate of return framework, accelerated depreciation or some combination of both. Similarly, investor expectations in this infrastructure may not be the same as investor expectations in essential services infrastructure. Therefore, Aurizon Network recommends the QCA maintain some flexibility in respect of the treatment of inflation in the regulatory model and define the conditions where it considers a real rate of return target should be applied.

Finally, in relation to the treatment of inflation in the regulatory framework Aurizon Network maintains that:

> *Where feasible and appropriate, regulated businesses should retain the ability to negotiate key matters impacting revenue and prices – including the treatment of inflation – having regard to the circumstances of the relevant industry and the market environment in which they operate[3].*

Medium to long term inflation expectations anchor point

Aurizon Network welcomes the QCA's recognition that continuation of its current approach to estimating forecast inflation may not be consistent with the following conditions:

- the monetary policy target is not 2.5%;
- medium to long term inflation expectations may fall within the monetary policy target range of 2% to 3% over the medium term; and
- inflation expectations may not revert to the midpoint of the target band within 3 years.

As such the continuation of the QCA's current approach could produce materially biased estimates of forecast inflation. The Draft Report therefore proposes to:

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[1] Aurizon Network (2021) Submission to QCA Issues Paper on Inflation Forecasting Review 2021, May

[2] QCA (2021) Draft Position Paper: Inflation Forecasting Review 2021, July, p. 7

[3] Aurizon Network (2021) Submission to QCA Issues Paper on Inflation Forecasting Review 2021, May

- retain the current RBA short term inflation forecasts for years 1 and 2;
- assume a linear glide path approach to medium to long term inflation expectations anchor in year 5;
- assume the RBA midpoint from year 6 (where this might be applicable);
- apply a rules-based approach to determine the medium to long term inflation expectations anchor from the second-year forecast where if:
    - less than or equal to 2 per cent, the anchor point would be set at 2.25 per cent; or
    - between 2 per cent and 3 per cent, the anchor point would be set at 2.5 per cent; or
    - greater than or equal to 3 per cent, the anchor point would be set at 2.75 per cent; and
- match the term of the inflation forecast with the term of the regulatory pricing period.

The following example shows the comparison of this approach with the QCA's current methodology for a business whose averaging period was June 2021 and was subject to a 4-year regulatory period.

Table 1. Draft Report Proposal for Inflation Forecasts

	RBA Short Term Forecast		Inflation Glide Path		Inflation Anchor	RBA Midpoint
Period	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6+
Forecast Rate	1.25%	2.00%	2.08%	2.17%	2.25%	2.50%
Geometric Mean Years 1 - 4	**1.83%**					

Table 2. QCA Current Approach to Inflation Forecasts

	RBA Short Term Forecast		RBA Midpoint	
Period	Year 1	Year 2	Year 3	Year 4
Forecast Rate	1.25%	2.00%	2.50%	2.50%
Geometric Mean Years 1 - 4	**1.99%**			

The inflation forecast obtained from the QCA's proposal in the Draft Report is more closely aligned to current economic conditions and the RBA's commentary regarding forecast inflation over the medium term.

Aurizon Network supports the QCA's draft proposal and considers it will substantially reduce policy induced bias and produce more reliable estimates of forecast inflation than the current approach. The QCA's proposal in the Draft Report also has the following enduring features:

- it operates symmetrically for sustained periods of high or low inflation;

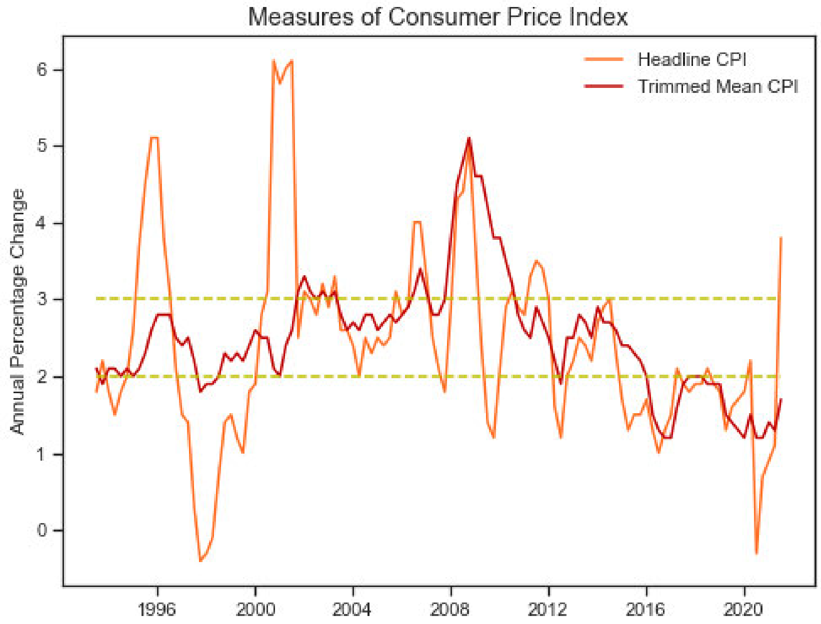
- it is simple and easy to understand while the RBA continues to produce second year inflation point estimates; and

- in periods where the RBA short term forecasts are sustainably within the inflation target range the approach will produce equivalent results to the QCA's current approach.

Aurizon Network recognises the simplicity and certainty provided by a rules-based approach but considers the year five one year forward rates for zero coupon inflation swaps and bond-break even inflation rates obtained from the term structure will continue to provide a reasonableness check on the anchor point. In particular, these market-based measures may also provide information relevant to both the anchor point and the speed of any reversion to that anchor point.

In addition, while historically there has been little difference in the RBA second year forecasts for headline and underlying inflation (as represented by trimmed mean inflation) the underlying inflation forecast is likely to be a better proxy for longer term inflation expectations. Underlying inflation is also significantly less volatile than headline CPI as shown in figure 1. It is recommended the QCA include in its final report which inflation measure the QCA intends to apply the rules-based approach to determining the anchor point.

Figure 1. Headline and Underlying Consumer Price Inflation



Source: RBA Series G1. Accessed 10 September 2021.

Should you have any queries in relation to this correspondence please contact Dean Gannaway at dean.gannaway@aurizon.com.au.

Kind regards,

Jon Windle
Manager Regulation