IM Review Discussion Forum

Allocation of risk under price-quality regulation

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Greg Houston

Partner, Sydney

Indexation of the RAB and price path
or
Options for managing inflation risk

In a CPI-linked price or revenue cap regime, the *intrinsic* risk of inflation being different from forecast is minimal

- MAR for five years set by reference to *forecast* inflation (for all variables, including RAB indexation/revaluation
- Consumer prices paid are adjusted annually by reference to *outturn* inflation

Under Australia's National Electricity Rules, and PTRM/RFM models

- RAB roll forward is finalised ex post, using *outturn* inflation
- No asset-value related inflation risk arises

Indexation of the RAB and long term price path

RAB indexation/revaluation has other long term price effects

- At 2 per cent long term inflation, the return of capital for a 50 year asset depreciated on a straight line basis is approximately zero in the first year
- Return of capital increases steadily over life of the asset, but is back-end weighted
- This phenomenon exacerbates the long term risks of disruptive technology
- Solution lies in rethinking depreciation profile, rather than indexation

But, long term risk management issues can be addressed through shape of depreciation profile

- With flexible/adaptable perspective on depreciation, RAB indexation canb be treated as separate issue of inflation risk management

Level 40, 161 Castlereagh Street
Sydney NSW 2000
Phone: +61 2 8880 4800

HoustonKemp.com