Office of the CEO

11 November 2019

Ms Clare Savage
Chair
Australian Energy Regulator
GPO Box 3648
SYDNEY NSW 2001

Dear Ms Savage

Regulatory treatment of inflation – Request for review

Thank you for your letter conveying the AER's decision that it will *not* hold a review in relation to its method for forecasting future inflation. I have become increasingly concerned with recent regulatory decisions and the potential implications for our business as we strive to deliver for the South Australian community. The recent list includes:

- the public lighting decision;
- the recent draft decision for our 2020-25 reset where despite being the most efficient business from a capital expenditure perspective on a state-wide basis, the draft decision cut our capex allowance by around $0.5Bn over 2015-20 actual capital spend;
- comments from an AER Board member indicating that the AER cannot look beyond the immediate regulatory period irrespective of the age profile of our assets, being the oldest assets in the NEM, with resulting long-term implications for consumers therefore not able to be taken into consideration, contrary to the NEO;
- [redacted] and
- the very recent decision on inflation.

The discussion below relates to the question of the best estimate of inflation forecast.

SA Power Networks remains deeply troubled by this decision in the current financial market conditions. As you know, the AER's allowed return on equity has now fallen to 4.75%, which is approximately 140 basis points lower than the allowance in the AER's 2018 Guideline. You are also aware that the actual return to equity holders will fall short of even the 4.75% allowance if actual inflation turns out to be lower than 2.45% over SA Power Networks' next regulatory period – due to an inconsistency in the way the AER's models make a deduction of 2.45% for expected inflation and then add back actual inflation.

SA Power Networks considers that the weight of evidence is now such that no reasonably-minded person could have confidence that actual inflation will be 2.45% over the forthcoming regulatory period. The material that the ENA presented to the AER last week includes:

- Evidence that actual inflation has remained materially below 2.5% in every quarter since the AER last reviewed this inflation problem in 2017. Actual inflation has now been below 2.5% for 20 consecutive quarters, which is unprecedented since the RBA began inflation targeting in the mid-1990s. Further, actual annual inflation has been below 2.0% in 18 of the last 20 quarters (on two occasions reaching 2.1%).

- A series of quotes from the RBA indicating that even it no longer expects inflation to immediately return to 2.5% after two years (which is the assumption that underpins the AER approach to inflation).
- Evidence that other market participants do not expect a recovery in the inflation rate in the foreseeable future.
- Evidence that the forecasts of future inflation published by the RBA (including market-based and survey measures) are all at, or very close to, their historical lows. These forecasts have all fallen materially since the AER's last inflation review.

Moreover, just last week the RBA commented that:

*The central scenario remains for inflation to pick up, but to do so only gradually. In both headline and underlying terms**, inflation is expected to be close to 2 per cent in 2020 and 2021.** Given global developments and the evidence of the spare capacity in the Australian economy, **it is reasonable to expect that an extended period of low interest rates will be required** in Australia to reach full employment and achieve the inflation target* (Statement by Philip Lowe, Governor: Monetary Policy Decision, 5 November 2019).

The RBA view was noted by the financial press, for example:

*The Reserve Bank has abandoned its expectation for any pick-up in wage growth over its forecast period and says **inflation will now not reach the bottom of its targeted 2-3 per cent range until 2022 at the earliest*** (The Australian, 7 November 2019).

The letter you provided last week cited the Consensus Economics survey forecast as the primary reason for the AER determining that no review of its approach to inflation was currently warranted. SA Power Networks does not consider that the CE survey should be treated as being singularly determinative:

- There are several methods that are used to forecast future inflation outcomes. The weight of evidence from the range of approaches is that inflation will *not* return to 2.0% within the next two years. For example, market-based approaches such as breakeven inflation and inflation swaps indicate that inflation will remain low for the foreseeable future. SA Power Networks considers that there is no basis for placing full weight on the one forecast that 'fits' the AER's approach, while affording no weight at all to other evidence – including comments from the RBA itself about the difficulty of increasing inflation.
- The letter refers to biases in relation to some market-based approaches. But what is important is the materiality of those biases, any adjustments required to correct for those biases and a proper consideration of the biases in the current methodology, particularly in a low-inflation and low-growth environment. Even if the AER is not minded to adopt a market-based inflation forecast, the fact that those forecasts are now at historical lows, and the fact that they are indicating very low inflation well beyond the forthcoming regulatory period, is reason to at least discuss the possibility that the AER's 'straight back to 2.5% after two years' approach might not be appropriate in the current market conditions.
- The Consensus Economics survey consistently indicates that inflation will return to 2.5% within two years (the AER noted that in its 2017 Inflation Review). This 'straight back to 2.5% after two years' forecast has been consistently wrong for some time now and there is no reason to expect it to now be correct.
- The AER does not use the Consensus Economics survey when setting inflation expectations, so it is odd that the AER relies on that survey to support its current approach.

SA Power Networks is deeply concerned about the AER's approach to this issue. This is a very important issue for all networks because the result is that actual returns have been falling short of the (record low) allowed returns for some years now and the weight of evidence indicates that this under-compensation is likely to increase for the foreseeable future. I note that SA Power Networks is simply asking the AER to conduct a review due to the importance of this issue, the fact that the mis-match in the AER's models has persisted for over 5 years now, and the fact that there is a weight of evidence indicating a continuation of the issue for the foreseeable future. It is difficult to imagine a more compelling case for the AER to open a review.

SA Power Networks is particularly concerned on three fronts:

- Confidence in the regulatory framework: A loss of confidence occurs when a regulator refuses to review an issue that is material, has been persistent for several years, and where the weight of evidence indicates that issue is likely to persist for the foreseeable future. Confidence is also damaged when a regulator gives disproportionate weight to one piece of evidence that it can find to support its case and rejects the weight of other evidence.
- Current market conditions: The AER's current methodology struggles in the current low-inflation low-growth environment.
- Incentive for investment: The mismatch in the AER's models results in actual returns falling short of even the record low allowed returns. This clearly has an impact on the incentive for efficient investment.

As this is an important issue that requires proper consideration, we will again request a review of this matter in our revised regulatory proposal.

I also note that the establishment of a working group into this matter illustrates that there is an issue that requires proper consideration. However, it is unclear as to the purpose of this working group in circumstances where the AER has already decided not to undertake a review. SA Power Networks is concerned that the AER's current approach will be adopted for the forthcoming regulatory period, locking in under-compensation for another five years as actual inflation outcomes continue to fall short of the AER's forecast. It is not clear to us how the working group process could address that concern. It is also very clear the working group timetable will not work to ensure proper consideration of this issue prior to our 2020-25 Final Determination is made by the AER.

I would appreciate a face to face meeting with you so as to better understand the direction the AER is looking to take on this and other important issues which will a significant impact on the long-term interests of all South Australians.

Yours sincerely

[redacted]

Rob Stobbe
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