4 March 2020

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

Email: [redacted]

Copy: [redacted]

Dear Ms Savage

SA Power Networks - Determination 2020-25

I am writing to you in relation to the impact of recent events on the AER's revenue determination for SA Power Networks for the forthcoming regulatory control period.

At the outset, I would like to emphasise that we understand the AER's position regarding late submissions. We ordinarily would not seek to make submissions at this late stage of the process. However, in light of the unprecedented events that have occurred over the past two months, we consider it necessary to highlight the potential implications of these recent events for the AER's final determination.

I am concerned that events outside our control, particularly the outbreak of Coronavirus and the effect of this on global financial markets, could have a significant impact on the final determination outcome. If the AER proceeds to adopt largely the same approach as in its draft determination, the effect of these external events is likely to be that SA Power Networks' revenue allowance in the final determination will not be sufficient to allow for recovery of our efficient costs and a level of return required to support efficient investment.

This letter outlines a path to avoiding these potentially adverse outcomes and ensuring that the final determination supports the long-term interests of consumers.

Unprecedented events over the last two months

As you would be aware, the outbreak of Coronavirus and escalating trade war tensions have rocked global financial markets. Heightened perceptions of risk have led to a 'flight to safety' among investors. This has in turn led to plummeting yields on long-dated Government bonds.

On 2 March 2020 yields on 10-year Commonwealth Government Securities (CGS), which are used to measure the risk-free rate, fell to an all-time low of 0.8 per cent (see chart below). For comparison, SA Power Networks regulatory proposal (lodged with the AER in January 2019) included a risk-free rate of 2.44 per cent, which was based on prevailing CGS yields in December 2018.

The decline in CGS yields has been associated with exceptional conditions in financial markets. There is evidence that, in just the last two weeks, perceptions of market risk have significantly increased. The ASX200 volatility index (one of the ‘conditioning variables’ regularly reviewed by the AER) has spiked in the past two weeks. Forecast dividend yields (also recognised by the AER as an indicator of heightened market risk) have similarly spiked. At the same time, estimates of the prevailing market risk premium from the AER’s dividend growth model have significantly increased. Recent evidence from these market risk indicators is set out in Attachment 1.

Effect of record low CGS yields

Under the AER’s current methodology for estimating the return on equity, a 1.6 percentage point decline in the risk-free rate (as has occurred over the past fourteen months since we lodged our proposal) translates into a 1.6 percentage point reduction in the allowed return on equity. This one-for-one reduction in the allowed return on equity occurs regardless of what has caused the decline in the risk-free rate. Any corresponding change to market risk is not accounted for under the existing methodology.

Just in the last two months since the outbreak of Coronavirus, the risk-free rate (and therefore the allowed return on equity as calculated by the AER) has fallen by around 40 basis points. This alone would lead to a significant reduction in our revenue allowance for the 2020-25 regulatory control period.

Such a reduction in our revenue allowance would not reflect any change to the efficient cost of delivering network services. The decline in CGS yields has not led to any reduction in the cost of operating and maintaining our network, nor does it reflect any change in the efficiency of our operations. There also has not been any reduction in the level of returns required by equity-holders to support ongoing investment. The decline in CGS yields is due to factors entirely outside of our control and unrelated to the efficient cost of serving our customers.

It is certainly not the case that the outbreak of the Coronavirus has reduced the efficient cost of delivering electricity network services in South Australia. Moreover, it seems incongruous that allowed returns should be subject to a lottery in which allowed revenues and the prices paid by consumers depend materially on whether or not the averaging period for a particular business happens to occur during a medical pandemic.

SA Power Networks has previously raised significant concerns regarding under-compensation for investors due to serious shortcomings in the AER's method for forecasting inflation. In a low-inflation environment, the AER's methodology will systematically deliver an overall revenue allowance that is not sufficient to provide for recovery of efficient costs. In our Revised Proposal we showed, based on estimates of the return on equity and forecast inflation at that time, that the AER's approach would in fact deliver a negative net profit after tax for SA Power Networks.[1] This is clearly not sustainable, and therefore not in the long-term interests of consumers.

A further decline in CGS yields associated with the outbreak of Coronavirus only exacerbates this problem. Even as the AER's allowance for the return on equity continues to decline, forecast compensation for inflation through RAB indexation is unlikely to materially change, because the AER's forecasts of inflation are tethered to the mid-point of the RBA target range. Therefore the extent of under-compensation will only increase as CGS yields decline.

Ensuring that the overall decision is in the long-term interests of consumers

I would urge the AER to carefully consider the impact of these recent events on its final determination for SA Power Networks. Given the impact of recent events, the AER may need to make adjustments to certain elements of its decision, in order to deliver an outcome that is in the long-term interests of consumers.

In particular, given the recent (and potentially ongoing) impacts of the Coronavirus, it may be necessary for the AER to review the appropriateness of the averaging period to be used for measurement of the risk-free rate in its final determination. Given the dramatic changes in financial market conditions since we lodged our regulatory proposal, it is my view that the agreed averaging period is no longer appropriate, as it will not deliver a return on equity which reflects efficient equity financing costs. In these unique circumstances, it may for example be appropriate to use a longer averaging period, in order to deliver a return on equity which appropriately supports efficient investment.

Additionally or alternatively, the AER may take into account the impact of recent events on rate of return and revenue outcomes in coming to its overall decision. In particular, we understand the AER will be looking to ensure that it properly considers the interrelationship between the rate of return and other parts of its decision as required by section 16(1)(c) of the National Electricity Law. To the extent that the return on equity allowance is particularly depressed due to external factors, this may mean that other parts of the AER's determination may need to be reconsidered in light of the requirement that the overall revenue allowance be sufficient to allow for recovery of at least our efficient costs.[2] More broadly, the AER will be looking to ensure that its overall decision is one which contributes to the achievement of the national electricity objective to the greatest degree.[3]

[1] SA Power Networks Revised Proposal, 10 December 2019, Attachment 3 - Rate of Return, p 11.

[2] National Electricity Law, section 7A(2).

[3] National Electricity Law, section 16(1)(d).

One important interrelationship for the AER to consider is the relationship between the AER's estimates of the allowed return on equity and expected inflation. The significant decline in CGS yields associated with the outbreak of Coronavirus means that there is now an even wider gulf between the AER's forecast of inflation (which is largely based on RBA targets) and market expectations of inflation (as reflected in CGS yields), creating an even greater risk that SA Power Networks will not be adequately compensated for its efficient costs. The disparity between the RBA's targets and market expectations of inflation was recently confirmed by the RBA Governor, Dr Phillip Lowe, in evidence to the House of Representatives Standing Committee on Economics. When asked what would be required to get inflation to the middle of the RBA's target band by the end of 2021, Dr Lowe responded that "It's just not practical at the moment to get inflation back to 2½ per cent in two years' time or 18 months' time with monetary policy".[4]

Given record low CGS yields and evidence that inflation is unlikely to reach the midpoint of the RBA's target range in the short to medium term, it may be appropriate for the AER to make an adjustment to its inflation forecast for the 2020-2025 period, to account for the unique circumstances surrounding this determination. SA Power Networks considers that such an adjustment would be permitted without broader consultation, since it would only involve an adjustment to the AER's forecast for the 2020-2025 period, not an amendment the post-tax revenue model.

SA Power Networks would be happy to meet with you and the AER Board to discuss this important matter.

Yours sincerely

[redacted]

Rob Stobbe
CHIEF EXECUTIVE OFFICER
GPO Box 77, ADELAIDE SA 5001

[4] Evidence by Governor of RBA (Philip Lowe) to House of Representatives Standing Committee on Economics, 7 February 2020.

ATTACHMENT 1

New evidence of recent changes in market conditions following the outbreak of Coronavirus

1. *ASX200 volatility index*

As previously noted by the AER, volatility can indicate the degree of risk in the market. Over the last month, the ASX200 forecast dividend yield has increased materially.

Source: Bloomberg, AS51VIX.

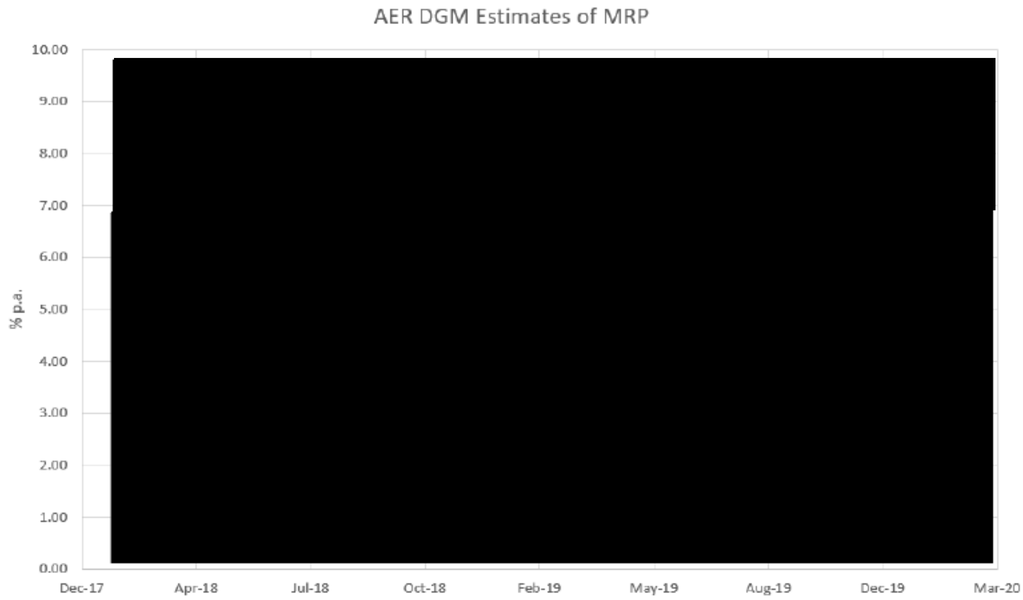
2. *Dividend yields*

Dividend yields, here represented by the average dividend yield of the ASX 200, can change in times of high market risk. Over the past two weeks, the ASX200 forecast dividend yield has increased materially.

Source: Bloomberg.

3. *Current estimates of the market risk premium using the AER's DGM*

Over the last two years, as government bond yields have fallen, the AER's DGM estimates of the forward-looking MRP have increased materially.



Source: Data from Bloomberg and RBA; AER two-stage DGM.

4. *ASX200*

The pronounced movements over the last month in the ASX200 volatility index and dividend yield conditioning variables indicate that the recent machinations in financial markets are risk-related. Investors perceive that risk has increased and this has resulted in a sell-off in equities with funds moving into government bonds.

Source: Bloomberg, RBA.