SA Power Networks

11 May 2020

Mr W Anderson
General Manager, Networks Finance and Reporting
Australian Energy Regulator
GPO Box 3131
CANBERRA ACT 2601

By email: sapn2020@aer.gov.au

Dear Mr Anderson

Inflation Forecast for SA Power Networks 2020-25 Revenue Determination

SA Power Networks was supportive of the AER delaying its Final Decision for our 2020-25 Regulatory Determination on the basis that this delay would allow the AER to improve its 2020-25 inflation forecasts for our Determination by incorporating latest inflation forecasts from the Reserve Bank of Australia (RBA), due 8 May 2020. The RBA's 8 May update provided annual inflation forecasts for June 2020 (-1%), December 2020 (0.25%), June 2021 (2.75%), December 2021 (1.25%) and June 2022 (1.5%).

I understand from discussions with AER staff members on 8 May 2020 that the AER is currently proposing to use the most recent RBA inflation forecasts for the years ended June 2021 and June 2022 to include in its estimate of expected inflation over the 2020-25 regulatory control period. An 8 May email received from the AER's pricing team advising the real revenue and real WACC for Year 1, further reflects this decision.

Under its regulatory approach, the AER first estimates the nominal required return on capital. The AER then makes a deduction in relation to the expected benefit of the regulated asset base (RAB) indexation and the remainder flows through to allowed revenues. That is, the deduction is made in relation to the expected benefit of RAB indexation such that these two amounts cancel out so as to eliminate any double counting of inflation.

For practical timing reasons:

- the deduction that is made when setting allowed revenues is usually based on the RBA's June-June inflation forecast; and
- the indexation of the RAB is usually based on observed inflation over the December-December calendar year.

This timing difference is usually of little consequence because the AER's June and December forecasts generally do not differ materially.

However, there is currently a highly material difference due to the extraordinary and temporary government intervention in making childcare free for the June 2020 quarter. This has the effect of materially reducing the CPI index as at June 2020. Of course, the index will simply increase again when the temporary government subsidy is removed, and childcare prices return to normal. Thus, the government's childcare subsidy:

- has no effect on the December-December inflation forecast because the subsidy is introduced and removed within the calendar year; but
- has a material effect on the June-June inflation forecast because the CPI index at June 2020 will be artificially depressed by the subsidy, in which case forecast inflation for the period to June 2021 will be artificially high.

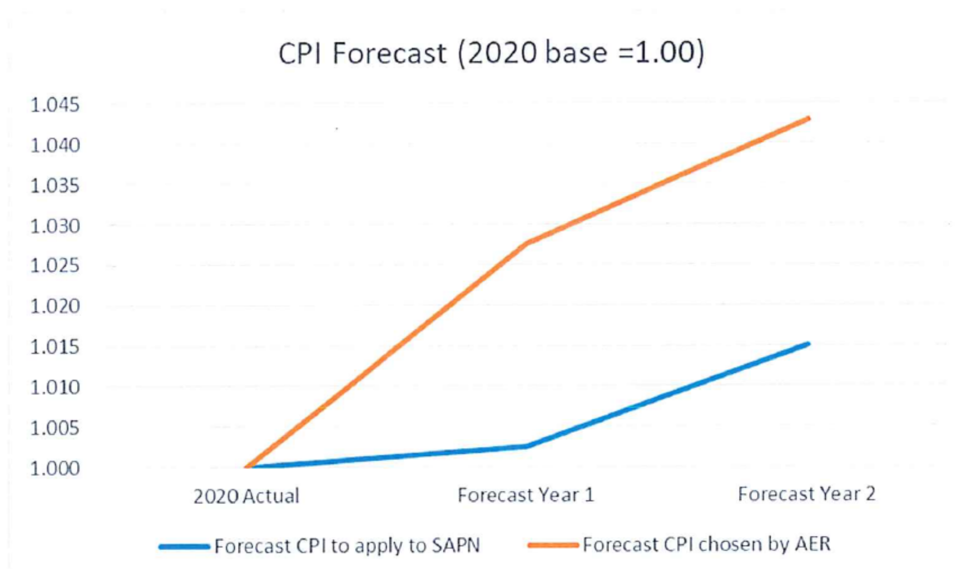
Consequently, even if inflation turns out precisely in line with the RBA forecasts, a problem arises if:

- the deduction that is made when setting allowed revenues is based on the RBA's June-June inflation forecast, which is artificially inflated by the effect of the government's temporary childcare subsidy (2.75% to June 2021); and
- the indexation of the RAB is based on observed inflation over the December-December calendar year which is unaffected by that subsidy (0.25% to December 2020, 1.25% to December 2021).

This is clearly an extraordinary artificial timing difference that requires a common-sense approach to ensure that the deduction that is applied to allowed revenues reasonably matches the expected benefit of RAB indexation.

We are very concerned that adopting the June forecast (which is artificially high due to the temporary government subsidy) increases the AER's 2020-25 forecast from 2.35% to 2.42% and does not result in the 'best estimate of expected inflation' over the 2020-25 period. In fact, by adopting this approach in our final revenue determination, the AER will be locking in a permanent under-compensation during the 2020-25 regulatory control period which will not be able to be recovered during subsequent regulatory control periods.

Set out below is a graph which demonstrates the divergence between adopting the June inflation forecast as compared to the December inflation forecast from the 8 May 2020 RBA Monetary Policy Statement.



The orange line in the above chart is the deduction to be applied when setting allowed revenues, and the blue line is the expected benefit of RAB indexation.

We propose the AER should include the RBA's December 2020 and December 2021 inflation forecast data. We understand it is open to the AER to adopt these December estimates, that is: there is nothing binding on the AER to adopt June forecast figures in its methodology.

If the December inflation forecasts are used as the best estimate of expected inflation, this will result in a cumulative 1.5% escalation in SA Power Networks' tariffs and RAB over years 1 and 2 of the 2020-25 regulatory control period.

Using the RBA's June 2021 and 2022 CPI forecasts in its 'estimate of expected inflation' over the first two regulatory years of the 2020-25 regulatory control period results in a cumulative 4.3% escalation over the first two regulatory years of the 2020-25 regulatory control period. However, this escalation is not incorporated into the adjustment to our RAB or tariffs because we must use the December CPI forecasts for the purposes of those adjustments.

This results in a significant and permanent 2.8% distortion (under-compensation) over the 2020-25 regulatory control period which cannot be recovered during subsequent regulatory control periods.

Adopting a CPI forecast which creates a significant distortion and results in a permanent and material under-compensation over the 2020-25 regulatory control period is clearly not the 'best estimate of expected inflation', particularly when an alternative estimate of expected inflation based on the December CPI forecast:

- is available;
- will align with the actual CPI used to determine the adjustments to our regulatory asset base and tariffs during the 2020-25 regulatory control period; and
- avoids the distortion caused by incorporating the June 2021 RBA forecast in its methodology without also incorporating the June 2020 forecast.

Adopting the December forecast would result in a forecast of inflation in our final determination of 2.15%. This results in the forecast being consistent with the CPI which will be applied to our tariff and RAB escalation. In also ensures that both the spike down and spike up in inflation arising by the temporary Government childcare subsidy is included in the forecast CPI.

The post-tax revenue model does not specify that the AER must use the June CPI forecasts. Rather, the PTRM handbook simply refers to the 'geometric average based on the inflation forecast for two years sourced from the latest available RBA statement of monetary policy and the midpoint of the RBA's target inflation band for five years'.

We understand that the AER has noted that it has always been its practice to adopt the June CPI forecast as the estimate of expected inflation for the purposes of revenue determinations. However, there exists several examples where the December CPI forecast has been used by the AER. The use of the June forecast is internally inconsistent with the regulatory modelling of our RAB and the price control mechanism used for determining our annual revenue which has been based on December inflation data since 2015.

In any event, past practice does not justify adopting an approach which does not result in the best estimate of expected inflation in the current economic conditions. This is the primary duty of the AER under clause 6.4.2(b)(1) of the Rules and the AER is obliged to adopt the inflation data that best achieves this outcome.

As noted by the RBA, the short-term childcare subsidy introduced by the Australian Government in response to COVID-19 is one of the main causes of the unprecedented movement in the RBA CPI forecast from June 2020 (-1%) to June 2021 (2.75%). It would clearly be inappropriate to adopt an estimate of expected inflation which does not consider both sides of this extraordinary impact in the AER's averaging approach. This would not be the *'best estimate of expected inflation'*.

Even this forecast of inflation is likely to be higher than the actual level of inflation during the 2020-25 regulatory control period taking into account the current material economic downturn and the fact that the RBA inflation forecasts are usually higher than the actual inflation rates based on historical data.

The end result would be that consumers will still benefit from tariff reductions, but the long-term interests of consumers will not be adversely impacted by locking in an inflation forecast that will result in a permanent under-compensation over the 2020-25 regulatory control period.

In light of the above issues, we request you urgently re-evaluate the 8 May 2020 RBA forecast inflation figures and include the December 2020 and December 2021 forecasts in the determination of the 2020-25 average inflation forecast in lieu of the June 2021 and June 2022 figures.

Should you require further information on any of these matters, please contact me on

Yours sincerely

Richard Sibly
HEAD OF REGULATION
GPO Box 77, ADELAIDE SA 5001

cc: Robert Stobbe, Chief Executive Officer
Patrick Makinson, General Manager Governance and Regulation