

Mr Warwick Anderson
General Manager, Networks Finance and Reporting
Australian Energy Regulator
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By email to: AERinquiry@aer.gov.au

Re: Proposal to delay final decision for SA Power Networks, Energex, Ergon Energy, Directlink and Jemena Gas Networks

Spark Infrastructure has a 49% interest in SA Power Networks (SAPN), the electricity distribution network in South Australia. SAPN provides electricity distribution services to around 900,000 residential and business customers and employment to more than 2,000 South Australians.

We support the AER's proposal to delay SAPN's final decision to enable the short-term inflation forecasts provided in the RBA's May monetary statement to be incorporated in the decision.

Whilst we support the above proposal, we note that the AER's methodology will still not provide a reasonable forecast of expected inflation, notwithstanding that the RBA's May monetary statement is expected to include a further lowering of the short term forecast of inflation in response to the impact of the COVID-19 economic crisis. Hence, while the size of the forecast error from the AER's methodology should be lower, this will only make the AER's current error 'less wrong'.

Continuing to overestimate inflation for regulatory purposes will not provide an allowance that reflects the regulated returns provided for under the Rate of Return Instrument. It will also reduce further the anomalous and artificially low rate of return for regulated businesses at this time with the effect of impairing SAPN's ability to return to normal operating circumstances as quickly as possible. It will challenge SAPN's ability to retain its workforce and invest in the network to support the current and future needs of customers and the electricity system over the next five years. As a result, SAPN will be impaired in its ability to recover from this crisis over the next five years of its new determination, well beyond the expected recovery timeframe of other businesses. This is not in the best interests of customers.

This carries significant consequences as Australia is dealing with the current pandemic crisis caused by COVID-19 and will need to do everything possible to recover from the severe economic impacts as quickly as possible.

The current methodology for forecasting inflation is flawed

The AER's methodology for forecasting regulatory inflation for use over the next 5 years is, paradoxically, based on a 10-year approach. The forecast formula draws two data points from the RBA's forward estimates of actual inflation for the next two years and eight data points (i.e. an 80% weighting) from the mid-point of the RBA's target range for inflation (i.e. 2% to 3%), which is therefore 2.5%.

Importantly, 2.5% is not actually an RBA inflation target, it is just the mid-point of its target range. In practice, the RBA will be satisfied if inflation increases back up to 2.0%, being the bottom of its range, and will have no reason to act further to increase inflation back to the mid-point once inflation is within

the target range. Nevertheless, irrespective of where the updated RBA two year forward estimates for inflation come out, the AER's estimate will remain anchored to 2.5% for regulatory purposes.

In reality, there is no evidence that inflation will return to, or is expected to return to, an average close to 2.5% over the next 5 years. Inflation has not returned to the mid-point of the RBA's target band for 5 years and is not expected to any time soon. The RBA now accepts that inflation will be lower for longer per its own statements.

The AER has a responsibility to ensure best estimates are applied across its regulatory decisions. After many representations to the AER over the last year, including a request from SAPN that such a review should be concluded in time for its final decision, the AER has only recently announced that it will undertake another review of its inflation methodology. This review is however expected to conclude in December 2020 after the final decision for SAPN has been issued.

Clearly there is a fundamental flaw in the AER's process for estimating inflation, which is now widely understood, and SAPN should not be penalised for that fact for the next 5 years. Accordingly, the SAPN final decision should be automatically amended in due course for any changes that are subsequently made as a consequence of the AER's review of its inflation methodology.

Please feel free to contact me to discuss further.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Rick Francis', written in a cursive style.

Rick Francis
Managing Director and CEO