SA Power Networks 2020-25 Distribution Determination in light of COVID-19

April 2020

SA Power Networks

Empowering South Australia

Our response to the impacts of COVID-19

- We acknowledge the profound impacts that COVID-19 is having on our community and economy. We are doing our utmost to protect vulnerable residential customers and support businesses.

- Together with other network businesses, we will ‘share the pain’ by forgoing and deferring tariff revenue and working with retailers to implement these measures expediently.

- We have made and are continuing to make adjustments to our business operations to better support our employees and the community through this crisis.

- All these measures have significant and ongoing cashflow implications for our business and this will worsen as the economy moves into recession.

- Our capacity to continue to support the community is dependent on the AER’s decision concerning our revenue for the next RCP.

Economic impacts of COVID-19

- The 2020-25 revenue determination process assumes that certain economic conditions will exist during the early years of 2020-25.

- COVID-19 and the resulting and rapid material deterioration in economic conditions leading to recession means that most assumptions are now incorrect.

- Accepted regulatory practice plus the NEO and revenue and pricing principles **do not** support the making of a revenue determination based on incorrect economic assumptions.

- This is not a ‘business as usual’ situation where ‘ups and downs’ even out over time. This is an unparalleled health and economic crisis that will continue to impact our business for a number of years.

- Our next revenue determination needs to recognise these issues and provide a workable glide path back to economic normality.

- As the economic regulator for network businesses we are seeking the AER’s support to mitigate the impact of this crisis on the viability of our business and therefore our ability to support customers.

Some of our current COVID-19 concerns

- We have raised a number of potential issues with the AER on several occasions. However, we expect that new issues will continue to emerge over the next 6 months.

- We have also provided our initial high level views concerning the likely adverse consequences to our business resulting from these issues. We expect that the actual adverse consequences will prove to be worse should the crisis deepen as most expect.

- For example, it is clear that the assumptions concerning productivity, inflation, rate of return, expected cost inputs and superannuation scheme costs that underpin the draft determination and our revised proposal are no longer correct.

- If despite the material adverse change in economic conditions these assumptions are used to underpin our final determination, we will be prevented from recovering our efficient costs.

- This is not a ‘*business as usual*’ impact and changing operating practice is unlikely to materially reduce this under recovery.

COVID-19 impacting on ability to comply

Other potential impacts are likely to include:

- Increased risk of failing to meet service standards due to constrained working conditions and limited available resources.
- COVID 19 social distancing requirements creating duplication, inefficiencies, delays and cost increases.
- Impact upon our ability to implement regulatory and system changes during 2020/21:
  - Ability of workforce to implement changes due to social distancing
  - Workforce shortages due to illness and self isolation
  - Ability to effectively consult / engage with stakeholders (eg new tariff structures)
  - Ability to implement system changes due to the need to address urgent system security and service delivery requirements

AER preliminary view on COVID-19

- We understand that the AER is contemplating:
  - deferring its final determination to mid-May to enable it to incorporate the RBA’s 8 May inflation update; and
  - potentially, undertaking a more fulsome consideration / whole-of-industry consultation on the impacts of COVID-19 at some time in the future.
- We acknowledge that this is the AER’s preliminary (without prejudice) view and that no final decision has been made.
- We understand the AER is seeking our initial thoughts on its preliminary position.

SA Power Network's initial feedback

- First, we need to better understand:
  - the options that have been considered by the AER to address COVID-19 issues in the context of new determinations commencing 1 July; and
  - the process for businesses to express views concerning those options.
- The potential issues we have raised to date are not addressed by the AER's preliminary position. There is no clear mechanism for addressing current issues let alone the issues which will inevitably arise during the next 6 months.
- SA Power Networks will be left in a position where:
  - it is required to operate under a revenue determination that assumes vastly different economic and working conditions;
  - the gap between these assumptions and reality are likely to widen; and
  - the only relief depends upon the outcome of a process that *may or may not* occur at an indefinite time in the future.

Our views concerning the fairest solution

- We do not believe that this proposal:
  - addresses the broader economic impacts of the COVID-19 crisis and likely recession; or
  - provides SA Power Networks with any comfort that it will be relieved from the adverse impacts of the incorrect economic assumptions that will underpin its final determination if it is issued in mid-May.
- We believe it is critical for all parties to work together now in a transparent and cooperative manner in order to identify a solution that balances the concerns and interests of all parties and provides the flexibility to respond to the rapidly changing conditions.
- Adopting a '*business as usual*' approach <u>as the AER is proposing</u> to the making of the final determination means that SA Power Networks will be negatively impacted from 1 July with no certainty that the negative impacts will be addressed.

Our views concerning the fairest solution

- Proceeding to issue a final determination which we believe is based on incorrect economic assumptions and locks SA Power Networks into a revenue and cost structure that is unsustainable over the 2020-25 RCP, <u>is not only contrary to the NEO and accepted regulatory practice but unfairly prejudices SA Power Networks as compared to other network businesses</u>.

- The AER has indicated that it may consider seeking a Rule change to address these issues on an industry wide basis.

- However, not all network businesses will be equally impacted and the appetite for this type of Rule change will be reduced once the immediate health crisis is over and we are faced with an extended period of economic rebuilding.

- This does not absolve the AER from its responsibility from what will be a materially incorrect decision.

Summary of SA Power Networks' position

- This crisis is unprecedented and requires SA Power Networks and the AER to work together to protect the most vulnerable, support the community and ensure that network business continue to operate in a viable manner.

- Our preference is to continue to engage with the AER to either agree:
  - a delay to the final determination to allow time to better assess and account for the impacts from COVID-19; or
  - address the material issues identified on slide 4 and in our previous correspondence to the AER.

- The allowed return on equity combines a MRP set during a steady economic expansion with a risk-free rate set during an economic crisis. This pairs a 'normal times' MRP with a 'crisis' risk-free rate that has been affected by record central bank intervention. The result is (inconsistently) low estimates for both parameters and a consequential reduction in the allowed return on equity. But a financial crisis caused by a global pandemic does **not** make equity capital cheaper!

- If the AER, as appears currently to be the case, does not address the impacts on us of COVID-19, this will impact our ability to continue to respond and assist those most:
  - impacted by this pandemic
  - vulnerable in the community.

Return on equity

- The averaging period for setting the risk-free rate reflects the market disruption caused by the COVID-19 pandemic. The RBA slashed interest rates and began a government bond purchasing program. Government bond yields have fallen dramatically as a result.

- The MRP in the AER's Binding Rate of Return Instrument was set prior to this market disruption and bears no resemblance to the risk premiums currently being seen in the financial markets.

- The result is an allowed return on equity that has **fallen** during a period of economic and financial crisis, which is nonsensical. It is clearly not the case that a financial crisis caused by a global pandemic makes equity capital cheaper.

- It is open to the AER to review the current rate of return instrument and replace it with an new instrument that reflects the current and expected extraordinary economic conditions.

What we propose

We suggest a possible way forward will be:

- if the AER changes their inflation forecast methodology after our Final Determination, then there should be a retrospective inflation forecast adjustment for SA Power Networks to reflect the change in methodology.

- to ensure that our 2020-25 Return on Equity more accurately reflects current market conditions, it should be set either by:

  – adopting the Return on Equity determined for SA Power Networks in the 2015-20 RCP; or

  – adopting the RfR and MRP values at the time the 2018 Rate of Return Guideline was published.

- retain Opex and Capex forecasts determined through the 2020 determination process, with the exception that there should now be no productivity adjustment applied to the 2020/21 period.

- that the tax allowance be calculated consistent with the 2018 Taxation Review Final report.

Customer price outcomes

- We believe our way forward will result in material price reductions to customers on 1 July 2020. There is a need to balance the desire to give price cuts to customers on 1 July 2020 with the need to deliver a fundamentally sound determination.

- Alternatively, if the AER seeks greater immediate short term price reductions from 1 July 2020, then we propose the five year revenue requirement be smoothed over the remaining 4 years.

Conclusion

- Governments and the broader community have a clear expectation that regulators and businesses will work together in a cooperative and flexible manner to urgently address COVID-19 issues and to minimise and mitigate adverse consequences to businesses, the community and the economy.

- There are numerous recent examples where Governments, Banks, regulators, businesses, landlords and other stakeholders have set aside '*business as usual*' models of operation to embrace innovative '*out of the box*' options for addressing COVID-19 issues and impacts.

- SA Power Networks is ready to work with the AER to identify these options and the energy industry and broader community need the AER to engage on these matters during this crisis.

- *There is a need to balance the desire to give price cuts to customers on 1 July 2020 with the need to deliver a fundamentally sound determination.*

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