5 November 2020

Mr Warwick Anderson
General Manager, Networks Finance and Reporting
Australian Energy Regulatory (AER)
GPO Box 520
Melbourne Vic 3001

Dear Mr Anderson

DISCUSSION PAPER: REGULATORY TREATEMENT OF INFLATION

Endeavour Energy appreciates the opportunity to respond to the AER's draft position paper on its review of the regulatory treatment of inflation. The draft position paper broadly covers two key issues:

1. **Forecasting methodology:** the AER proposes moving to a 5 year estimation period with a glide-path from the RBA's forecast of inflation for years 1 and 2 to the mid-point of the inflation target band (2.5%) in year 5. The AER pose the question of whether a transition is required to this new approach (if implemented).

2. **Structural issue:** The AER considers the current approach delivers the initial real rate of return. Further, the above changes to the inflation forecasting approach should resolve concerns that it does not. However, the AER does consider alternative options in the draft report and concludes that if a change were to be made, a nominal framework would be preferable to a hybrid one primarily due to regulatory precedence.

In our response to the draft position paper we provide this brief response to the key issues and questions raised in the paper. For our more detailed position we refer the AER to the ENA's submission to this review, which we fully endorse.

Forecasting inflation

To summarise our position, we support the AER's proposed adoption of a glide-path method with a 5 year estimation period (new approach). The AER has, correctly in our view, determined that the new approach will produce a better estimation of inflation than the current 10 year geometric mean approach (old approach).

This decision clarifies the role of inflation in the regulatory framework, i.e. inflation is set to ensure that what is taken out of allowed revenues is equal to what is expected to be put back in. It therefore follows that what is required is to match the deduction from allowed revenues that occurs in the PTRM with the expected benefit of RAB indexation that occurs in the RFM. The new approach will deliver this by ensuring that the PTRM deduction will be based on the expected value of 5 years of inflation followed by the RFM which will add back 5 years of actual inflation.

Whilst the new approach is superior to the old approach we consider further improvements could be made through the use of market data. We note the AER has decided against the use of market-based measures in the draft position paper due to perceived biases. We do not consider market-based measures will diminish the new approach. For instance, the performance of the year 2 inflation estimate of inflation swaps has been materially closer to actual performance than the RBA's year 2 forecast over the last decade.

We note the AER's comments on expected inflation being distinct from actual inflation, however we consider the historical performance of a forecast against actual outcomes remains the best means by which to assess the accuracy of a forecast. We recommend the AER has further regard to market-based estimates. If the AER's concerns remain in applying direct weight to market-based estimates they may still provide value in informing whether the year 5 endpoint should be set at 2.5% or somewhere else within the RBA's target range.

Implementing the new forecast

An open question in the position paper is whether there should be a transition between the old and new approach discussed above. We are strongly of the view that there is no need or logical basis for transitioning to the new approach. As the AER has identified in the draft position paper, the new approach will produce a better estimate of inflation so any dilution of it would violate the NPV=0 principle.

A mismatch problem has been identified in the current approach; 10-year inflation is deducted but 5-year inflation is added back. The inflation estimate is then reset every 5 year period before this mismatch can be rectified (i.e. whilst the regulatory inflation figure includes estimates for years 6 through 10, these years have no impact on allowed revenues in years 6 to 10). The AER's proposed new approach resolves this mismatch and should therefore be implemented to avoid windfall gains or losses and ensure the National Electricity Objective (NEO) and Revenue and Pricing Principles (RPP) are met.

The new approach represents a change in a parameter rather than a change in the framework. It simply involves the re-weighting of the three pieces of evidence that are currently used to estimate inflation. It requires no changes in the assumptions about how the benchmark efficient firm would be operated. It requires no change to any regulatory model outside of using a different figure for the estimate of inflation. As noted above, inflation is estimated anew every 5 years meaning the current 10-year estimate has no impact on a subsequent regulatory control period that needs to be managed.

The change is akin to changes in other parameter estimates which have been made before without any need for a transition, such as the equity beta and market risk premium. It is distinct from the change in the approach to the cost of debt which was a framework change proceeding a rule change and requiring a change in the assumed practices of the benchmark efficient entity.

It is incorrect to characterise the change as creating the potential for windfall gains or losses against an NPV neutrality criteria. The criteria should not be neutrality with the old approach but neutrality over time (i.e. the NPV of an unbiased forecast over time will tend towards zero) and windfall gains and losses arise from the violation of this principle. Waiting to implement the new approach or implementing it in a way that replicates the old approach would defeat the purpose of making any change and create windfall losses that will not be corrected in future periods.

We are therefore strongly of the view that the AER has identified a superior method that addresses the mismatch issue. To achieve the NEO and determine the best estimate of inflation the AER should immediately implement the new method in full and without transition.

Structural issue

We note the AER's concerns with implementing a framework change to adopt a full nominal or hybrid return framework. We accept that this issue will not be progressed via this inflation review and will instead require a rule change (noting the AER does not intend to submit a rule change request).
We remain of the view that the hybrid approach proposed by the ENA has a number of advantages and, if implemented, would more fully address the issues discussed above and eliminate the risk of NPV=0 violations. Specifically:

- A hybrid approach is simple, not complex, to implement. It only requires the RAB indexation in the RFM to be done using the forecast inflation used in the PTRM.
- There would be no impact on prices over the longer term provided the forecast of inflation is unbiased. If biased, the hybrid approach would help correct this as an added benefit.
- It matches the regulatory allowance with the cost that the AER considers to be efficient.
- It reduces the risk of credit-rating downgrades and other impairments in the ability to raise capital arising from actual inflation being less than forecast.

It is for these reasons we maintain our position that the hybrid model remains worthy of further consideration.

Financeability

We note that low inflation environment strains the current regulatory framework. Sustained and material negative profits cannot be offset via depreciation allowances or borrowings over the long term nor by incentive payments. These financeability concerns present a threat to the achievement of the NEO and RPP.

Overall, we welcome the new method outlined in the draft position paper and consider it should be implemented immediately and in full. This constitutes an important step in rectifying financeability issues and we welcome further open and evidenced-based engagement with the AER on this review and the 2022 Rate of Return Instrument review.

If you have any queries or wish to discuss our submission further please contact Patrick Duffy, Regulatory Strategy Manager at Endeavour Energy on [redacted] or via email at [redacted].

Yours sincerely

[redacted]

Rod Howard
Deputy Chief Executive Officer