Endeavour Energy

6 June 2018

Mr Warwick Anderson
General Manager
Australian Energy Regulator
PO Box 3131
Canberra ACT 2601

Via: AERinquiry@aer.gov.au

Dear Warwick,

RE: AER Draft Position Paper – *Profitability measures for electricity and gas network businesses (April 2018)*

Endeavour Energy welcomes the opportunity to provide feedback on the AER's draft position paper – *Profitability measures for electricity and gas network businesses* (the draft position paper). We support the Energy Networks Australia submission and provide our own submission to provide further feedback on the draft position paper.

In response to consumer concerns, the AER is undertaking a review to identify profitability measures that could be applied to electricity and gas service providers. We understand that the aim of the AER's review is to identify suitable profitability measures and their associated data requirements that would allow the AER to report and compare the returns of electricity and gas service providers they regulate.

Primacy of stakeholder confidence

Endeavour Energy believes that stakeholder confidence in the regulatory framework is critical for the long term sustainability and efficient operation of the regulatory process. We believe that stakeholder confidence can be enhanced through an effective and transparent review mechanism that reports meaningful and comparable measures of actual outcomes relative to regulatory decisions.

In order to support stakeholder confidence it is critical that information published by the AER is factual, capable of replication and within context. To achieve this objective care should be taken to ensure that the results published are presented in a manner that is resistant to short term natural volatility and misrepresentation, i.e. the data reported is measured over the longer term.

Sustained divergences versus natural variation

Section 2.7 of the draft position paper recognises that there is a number of exogenous factors that impact both the accuracy and comparability of the proposed profitability measures. The AER has reviewed the likely impact of one of these factors, incentive schemes and concludes that the impact on profitability measures is "on average" minor. This finding suggests that there were significant one-off impacts that result from the operation of incentive schemes that need to be averaged out and does not allay our concerns that the accuracy of annual performance measures can be significantly impacted by factors unrelated to underlying profitability.

In a similar vein, there are additional operational and environmental factors not reviewed by the AER that may impact the accuracy of annual profitability measures, such as the impact of year to year volume variation. Under a revenue cap framework, the 'overs and unders' system will ensure that the correct revenue allowance is recovered from consumers. In enforcing this outcome the timing of revenue collection is distorted. This distortion will be reflected in a number of the profitability measures proposed by the AER.

Finally, Endeavour Energy notes that, in making a regulatory decision, the AER applies x-factor smoothing to the underlying revenue building blocks to better manage the pricing impact on customers. While we agree with the smoothing process, it must be recognised that it disconnects the annual cost building blocks of the AER's decision from the annual revenue recovered by the business. This distorts the annual profitability of the business relative to the allowed annual rate of return.

The AER has stated that the profitability measures will be reported inclusive of a qualifying note to acknowledge any inaccuracy in the measure that results from the operation of the regulatory framework. Endeavour Energy believes that there is a material risk that measures calculated inclusive of these known inaccuracies will be misconstrued by stakeholders and used in a manner that may ultimately result in undesirable regulatory outcomes that are not in the long term interest of consumers.

To help mitigate this risk, Endeavour Energy recommends that the AER consider a reporting framework that helps smooth annual fluctuations caused by the regulatory framework so that any underlying profitability issues can be better identified. This could include:

- Using a multi-year moving average rather than an annual measure; or
- A 'high – low' range rather than a single point estimate.

Endeavour Energy recognises the AER's attempt to identify those profitability measures that give the greatest chance of achieving meaningful and comparable measures. We do not believe, however, that the earnings per customer or RAB multiple measures will achieve these objectives.

RAB multiples

While Endeavour Energy acknowledges that RAB multiples may provide insights to stakeholders, it is not apparent that they are suitable measures for regular reporting due to the infrequent nature of transactions, nor are they necessarily measures that provide direct insight to the commercial profitability of businesses relative to the regulatory allowances.

The reporting value of RAB multiple data will diminish over time. If the RAB multiple profitability measure is to be maintained by the AER they will need to consider an appropriate time at which to exclude historic RAB multiple data from their reporting. In addition, it would be prudent for the AER to provide stakeholders with guidance as to the rate of diminishing value of this measure over time.

Endeavour Energy believes that it would be more appropriate for the AER to maintain a watching brief on transaction outcomes as it is not apparent that this type of data is conducive to regular reporting.

RAB multiples are not available for all networks, further limiting their use as a comparable measure. Where they do exist they will be impacted by a number of factors that do not relate to underlying profitability. These factors may include:

- The timing of network transaction. Ongoing changes to energy policy and the regulatory framework has the potential to render historic RAB multiple data irrelevant.
- The nature of the competitive bid process combined with the scarcity of regulated infrastructure assets would be expected to draw a premium
- Investors may seek to invest in regulated infrastructure as the characteristics of the revenue stream (as distinct to the volume of the revenue stream) may provide a risk match to the investor that might attract a premium as opposed to being a direct evaluation of the investment itself.
- Investors may also have legal or contractual obligations to invest in regulated or inflation pegged assets, particularly where the investor is making investment on behalf of third parties in line with their preferences.

Endeavour Energy does not have expertise to quantify if or by how much such non-financial assessments may influence the realised RAB multiples in transaction processes, however their potential to influence the usefulness of this measure should be considered in determining the value of RAB multiples for regulatory purposes.

Endeavour Energy recommends that the AER remove RAB multiples from the suite of measures for regular reporting due to the matters raised.

If you have any queries or wish to discuss this matter further please contact me on [redacted]

Yours sincerely,

[redacted]

Jon Hocking
Manager Network Regulation
Endeavour Energy