

29 July 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 TREATMENT OF INFLATION**

Endeavour Energy appreciates the opportunity to respond to the AER's discussion paper on its review of the regulatory treatment of inflation. This paper broadly covers two key issues; what estimation methodology should be used to forecast inflation and whether the regulatory framework successfully delivers a real rate of return. With respect to the latter the paper considers alternative options such as targeting a nominal or hybrid return.

In our response to the directions paper, we provide this brief response highlighting our key concerns and suggestions. For our more detailed position we refer the AER to the ENA's submission to this review, which we fully endorse.

To summarise our position, the available evidence<sup>1</sup> indicates that the current approach is consistently over-estimating inflation (since 2015) which introduces avoidable volatility in real returns and increases the risk of customers and shareholders earning windfall gains and losses. In a low-interest environment, this results in equity holders funding debt costs and the embedment of negative net profit allowances.

It is not in the long-term interests of customers to be exposed to such volatility or the risks associated with financially unsustainable outcomes. We support the principles underlying the regulatory models and the need to ensure that the net present value (NPV) of an investment is zero and that a network maintains the real value of its capital investment.

We consider this review provides the AER with an opportunity to respond to the changing environment and reduce the risk that both shareholders and customers are exposed to in achieving the target rate of return. In line with the ENA's recommendations, we suggest the following solutions:

1. **Forecasting methodology:** use market forecasts, i.e. inflation swaps and the adjusted breakeven approach, to estimate inflation. Market approaches provide direct estimates that are commensurate with the role that the inflation parameter plays with the AER's regulatory framework. We consider market estimates will produce better and simpler results compared to a glide-path approach which requires fixing the start and end points and the transition path.
2. **Hybrid approach:** we recommend limiting the real framework to the equity component of the WACC whereby the debt portion of the RAB is indexed using the AER's forecast inflation. This approach satisfies the NPV=0 principle and results in consumers only having to pay the efficient cost of debt as determined by the AER. We also note the hybrid approach as advanced by the ENA is different to the hybrid approach assessed by Sapere.

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].

**Rod Howard**  
Deputy Chief Executive Officer

<sup>1</sup> Grattan Institute, The Recovery Book, 28 June 2020, Figure 3.10, p. 34