AER Discussion Paper

Allocations of interest and tax expenses for the calculation of return on equity (regulatory) profitability measure

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AUSTRALIAN ENERGY REGULATOR

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Contents

1 Allocations of interest and tax expenses for the calculation of return on equity (regulatory)

We are seeking views on the advice we sought from PricewaterhouseCoopers (PwC) on approaches to allocate interest and tax expenses from corporate groups to network service providers (NSPs) for determining the return on equity (regulatory) profitability measure.

PwC's advice will be used to inform our views on how these allocations could be made for our review into the types of profitability measures that could be applied to the NSPs we regulate. To further inform this discussion, we are seeking stakeholders' views on PwC's advice and the associated data that would be required to make these allocations. In forming a final position on the return on equity (regulatory) measure for our review, we will have regard to submissions from stakeholders and discuss our views on PwC's advice with the profitability measures review working group.

Stakeholders are invited to make submissions by 22 August 2019.

Further details of the profitability measures review and PwC's advice is available on the AER website.

1.1 Overview

We are undertaking a review to identify suitable profitability measures and the associated data requirements to allow us to report and compare the returns of the NSPs we regulate. In particular, we are seeking to identify profitability measures that will allow comparison of:

- expected returns of an NSP relative to its actual returns
- returns between NSPs in the same sector
- returns between the NSPs and other regulated/unregulated industries.

We consider reporting on the returns of the service providers will assist in the achievement of the National Electricity Objective (NEO) and the National Gas Objective (NGO) by making those returns and their drivers transparent. This should assist stakeholders in making submissions on NSPs regulatory proposals and to other regulatory processes. In addition, the information should assist us and stakeholders by providing an additional source of information with which to review the overall effectiveness of the regulatory regime.

In April 2018, we published a draft position paper which set out the six profitability measures we intend to report on (Table 1.1).[1] Four measures are based on regulatory accounting information and two measures are based on statutory accounting information. We consider the reporting of a suite of measures will highlight different aspects of profitability and allow a more comprehensive assessment of the drivers of profit. Further, reference to a suite of measures mitigates the impact of limitations in any one specific measure.

1 AER, *Draft position paper: Profitability measures for electricity and gas network businesses*, April 2018.

Following the draft position paper, stakeholders proposed that we take a staged approach to the review. In response to stakeholder feedback, we decided that the review will be progressed through the following two stages:

- We will publish a final position paper on the profitability measures and the development of information requirements required to calculate the measures based on regulatory accounting information by 20 December 2019.
- Further assessment of the profitability measures based on statutory accounting information to begin in 2020.

Table 1.1 AER draft position profitability measures

Proposed measure	Calculation
Return on Assets (Regulatory)	Regulatory Earnings Before Interest and Tax (EBIT) / Regulatory Asset Base (RAB), where Regulatory EBIT is for core regulated services and the RAB for core regulated services.
Return on Assets (Statutory)	Statutory EBIT for the Service Provider / Statutory Total Assets for the Service Provider.
Return on Equity (Statutory)	Statutory NPAT for the service provider / Statutory Equity for the service provider.
Return on Equity (Regulatory)	Regulatory NPAT / Regulated Equity, where Regulatory NPAT is for core regulated services, and Regulatory equity is determined by applying the benchmark gearing ratio to the RAB for core regulated services.
EBIT / customers numbers (Regulatory)	Regulatory EBIT / Total customer or connections, where Regulatory EBIT and customer or connection numbers are for core regulated services.
RAB multiples	Enterprise Value / RAB, where Enterprise Value is the total market value of the business as determined by reference to a sale value or based on the value of the company's shares (if listed).

Source: AER, *Draft position paper: Profitability measures for electricity and gas network businesses*, April 2018, Table 1.1, p. 3.

To assist in our review, we formed a working group of consumer and industry representatives to meet regularly and work through issues raised in response to the draft position paper.

One issue to be discussed at the working group is the proposed return on equity (regulatory) profitability measure and how allocations of interest and tax expenses to the NSPs from their corporate groups could be done for the purpose of determining this measure.

1.2 Advice sought on the allocations required for the return on equity (regulatory) measure

As set out in table 1.1, the return on equity (regulatory) profitability measure will be determined as regulatory net profit after tax (NPAT) over regulatory equity. Regulatory equity will be determined by applying the benchmark gearing ratio to the RAB for core regulated services.

For many NSPs, the determination of their regulatory NPAT will require allocations of interest and tax expenses from their corporate groups.[2] These allocations are required because these NSPs do not incur these expenses directly. In many cases, their financial and tax arrangements are managed at the corporate level.

While we acknowledge that these allocations are complex in view of differing corporate structures, we are of the view that it can be done. This is evidenced by some NSPs are already providing interest and tax information as part of their annual reporting requirements. We also acknowledge stakeholder views that, without clear guidance for making these allocations, they could be made on an arbitrary basis.[3]

To assist with our determination of profitability measures, we would seek to have all NSPs report interest and tax information and, where possible, have consistent allocation approaches to assist in comparability.

In order to progress our considerations on this issue, taking into consideration stakeholder views, we sought advice from PwC as follows:

- Produce a written report on the key principles and recommended methodologies used to allocate interest expense and tax expense for the purposes of reporting NPAT of NSPs on a regulatory accounting basis. Specifically, the report should set out:
    - the various corporate structures associated with the regulated business and how these impact upon how interest expense and tax expense should be allocated to the regulated business entity;
    - the key principles that should be applied to allocate interest expense and tax expense to the regulated entity;
    - the methodologies that could be used to allocate interest expense and tax expense to the regulated entity and in turn to the core regulated service, what circumstances they relate to and their advantages and disadvantages;
    - a recommendation as to what methodologies would be best applied in what circumstances;
    - whether the allocation methodologies would differ if we were trying to produce statutory accounting information (interest and tax expenses) for the regulated business entity rather than regulatory accounting information.

As noted, PwC's advice will be used to inform our final position on the return on equity (regulatory) measure for our review into the types of profitability measures that could be applied to the NSPs we regulate. To further inform this discussion, we are seeking

2 AER, *Draft position paper: Profitability measures for electricity and gas network businesses*, April 2018, pp. 11-13.

3 APA Group, *Profitability measures for regulated gas and electricity networks*, December 2017, p. 9; SAPN et al, *Discussion paper: Profitability measures for regulated network businesses*, 8 December 2017, p. 3; Energy Networks Association, *Response to the AER's discussion paper on profitability measures for regulated gas and electricity network business*, 8 December 2017, p. 3.

stakeholders' views on PwC's advice and the associated data that would be required to make these allocations. In forming a final position, we will have regard to submissions from stakeholders and discuss our views on PwC's advice with the profitability measures review working group.

1.3 Questions for feedback

We welcome stakeholder submissions on how we should take PwC's advice into account in determining our approach for the allocation of interest and tax expenses for the calculation of return on equity (regulatory) profitability measure. In particular, we seek stakeholder views on the following questions:

1. Do you agree with the key principles identified by PwC for the allocation of interest and tax expense to the regulated entity?
2. Do you agree with PwC's recommended approach for allocating tax expenses for corporate structures?
3. Do you agree with PwC's recommended approach for allocating tax expenses to flow-through tax structures?
4. In light of the advantages and disadvantages that PwC sets out for its three interest allocation approaches, which of these allocations should be used, and why?
5. Are there any further allocation approaches we should consider for tax and/or interest expenses? If so, please identify why you consider these approach/es preferable to those identified in the advice.