

30 May 2018

Mr Warwick Anderson  
General Manager  
Australian Energy Regulator  
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By email: [AERinquiry@aer.gov.au](mailto:AERinquiry@aer.gov.au)

Dear Mr Anderson

### **Profitability measures for electricity and gas network businesses = submission to AER Draft position paper**

APA accepts that reporting outcomes against regulatory determinations is a part of an effective regulatory regime, and APA supports initiatives of this type.

APA remains of the view that we must report against what it is we seek to measure. APA suggests that there are two indicators that are relevant to the ongoing monitoring of the regulatory framework's effectiveness:

- outturn performance against the regulatory determination's forecast outcomes; and
- the extent to which businesses have responded to the incentives inherent in the regulatory regime.

APA submits that any profitability reporting measure must be restricted to consistently-based regulatory inputs of revenue and asset valuation in order to avoid confusion in the marketplace.

APA cannot support initiatives towards reporting ratios which mix regulatory and statutory accounting measures – these will produce spurious information and will cause confusion in the marketplace.

In summary, APA:

<b>Supports these measures</b>	<b>Cannot support these measures</b>
Return on Assets (Regulatory)	Return on Assets (Statutory)
Return on Regulatory Equity (Regulatory)	Return on Equity (Statutory)

### **Outturn performance reporting**

APA considers that, in order for a financial ratio to deliver meaningful information, the inputs to that financial ratio must be derived from a consistent foundation. In this respect, APA is of the view that it would not be reasonable to produce a financial ratio which mixes regulatory-determined revenue (which is intimately linked to an indexed regulatory asset valuation) with asset valuation derived from historical cost statutory reporting.

Calculation of ratios that appear to be similar to those commonly used in competitive business performance evaluation will deliver spurious results as a consequence of the differing foundations of the underlying financial information. It will take a reader with a robust financial background to be able to interpret these results in order to make valid comparisons to similar ratios derived for competitive firms.

APA is concerned that publication of ratios that could be inappropriately perceived as being similar to those commonly used in competitive business performance evaluation risks misinterpretation and, as a consequence, unfounded concern amongst consumers and policy makers.

Of course the answer to this problem is information and education. If these ratios are to be published (and endorsed by the economic regulator) it will be important for them to be accompanied by sufficient explanatory information to demonstrate to users why the measures are expected to be different from those observed in the competitive marketplace. The need for explanatory information indicates that these "mixed measures" will fail the AER's Assessment Criterion 3 – they will not be easily understood by those without a financial background.

In contrast, ratios derived from regulatory information will produce internally consistent results. In this respect these measures will meet the AER's Assessment Criterion 5 - it would be possible to calculate financial ratios using regulatory information and use them to compare outturn performance of regulated businesses across the sector.

APA considers that internally consistent regulatory-derived ratios will be preferable to ratios which mix regulatory and statutory account information. Profitability ratios that straddle two financial reporting frameworks will not provide relevant informational value, owing to the confusion between the foundations on which the inputs are derived.

### **Incentives**

The AER Position Paper (p14) suggests that the impact of incentives in regulated business' revenues and profitability is minor, and sufficiently so that there is no need to adjust the reported outcomes to excise the impact of incentive mechanisms.

APA accepts this position as it relates to the formal incentive mechanisms developed by the AER – the STPIS, the CESS and to a lesser extent the EBSS.

However APA maintains that it is critical to adjust for the impact of incentives inherent in the regime. In particular, the Gas Access Regime is, at its core, a price cap regime that has been designed to encourage load growth in the gas sector. Load-driven revenue outperformance is an acknowledged incentive inherent in the regime.

As discussed many times in public submission and at the public forum, businesses are not at all clear how the AER propose to use these ratios. APA submits that if it is the AER's objective to use these profitability ratios to reduce or confiscate the volume-driven revenue outperformance of gas business, it will have undermined the very foundations of the Gas Access Regime.

APA looks forward to engaging with the AER and consumer representatives to develop a sound and relevant suite of profitability measures that can support the regulatory regime going forward.

To discuss any of the matters raised in this submission, please contact Scott Young on [REDACTED] or [REDACTED]

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General Manager Strategy and Regulatory