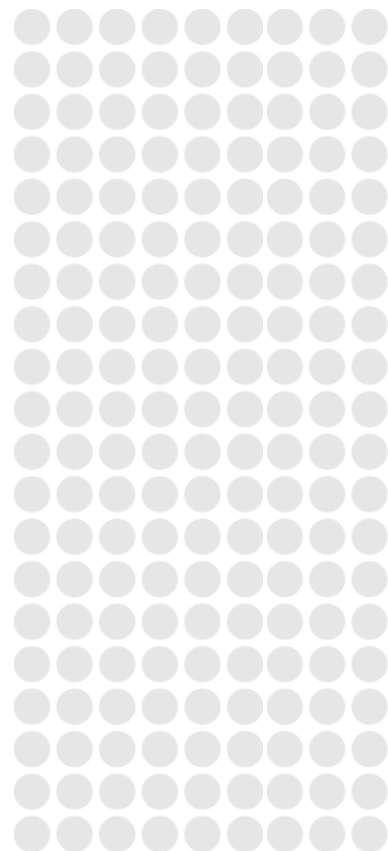
December 2017

profitability measures

for regulated gas and electricity networks.

apa group submission



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1 Key points

APA accepts that reporting outcomes against regulatory determinations is a part of an effective regulatory regime. APA also accepts that the Rules currently require less annual reporting for gas pipelines than for other elements of regulated infrastructure - while the NGL requires regulated gas pipelines to prepare and maintain regulatory accounts, there is currently no requirement to lodge them with the regulator.

APA considers that the purpose of the profitability reporting regime is to monitor performance against the forecasts inherent in the most recent regulatory determination and inform the AER's next regulatory review. It is in these review processes that the AER will reach regulatory decisions that will aim to promote the National Gas Objective.

To this end, APA is 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.

These themes form the key messages in this submission.

If we seek to measure performance against the AER-approved revenue requirement, our reporting measures must be calculated on a consistent basis – if we use different measures, we cannot be said to be reporting against the performance of the regulatory regime. Importantly:

- asset valuations must be based on the approved RAB rather than any measure of historical cost accounting as per statutory reporting guidelines and requirements; and
- reported revenue and expenditure must align with the scope of the regulatory determination (for example unregulated revenue); and

- allocation of debt, interest and tax must follow the regulatory decision rather than accounting values (for example, capital structure, regulatory treatment of imputation credits).

  These important elements are achieved by utilising the regulatory accounts as the source of the value for the inputs into the derivation of the measures.

Moreover, as identified in s2.2 of the AER Discussion Paper, we must also acknowledge the incentives inherent in the regime.

As outlined in the McGrathNicol report, there are a number of approaches to calculating some of these measures, in particular relating to the asset values on which some of them are based.

There is scope for inappropriate use of these reported values if they are not directly related to and calculated on a consistent basis with the intended outcomes of the regulatory regime.

It is important, then, that these profitability measures are reported on a forecast basis in the PTRM, and that the specification of these measures is also clearly and consistently delineated in both the Guidelines currently under consultation and the PTRM.

APA therefore recommends that these measures should be included as part of the upcoming PTRM review process.

1.1 A consistent foundation of measured values

APA is concerned with the McGrathNicol discussion on these measures, particularly relating to:

- translation of amounts from statutory accounts to regulatory accounts;
- use of accounting data instead of regulatory values; and
- measurement of asset values.

The AER accepts this point, as outlined in footnote 14 to its discussion paper:

> *While the McGrathNicol report has provided the method to calculate the profitability measures from both regulatory and statutory accounts, our focus is on the regulatory reporting of profitability. We note there*

> *are substantial differences between the regulatory and statutory accounts and consider that it may be misleading to compare the profitability of electricity and gas network businesses on a regulatory and statutory basis.*

McGrathNicol's discussion paper indicates that[1]

> *Ideally, use of a financial performance measure would allow the AER to:*
>
> > *compare profit of the regulated business to the statutory profit earned by the owner of the regulated business;*

APA submits that a comparison of regulatory returns to statutory profit is not a relevant measure, owing to the different foundations on which these measures are based. This matter, particularly relating to asset values, capitalisation and an absence of statutory reporting at the service provider level, are discussed below. APA is most concerned that McGrathNicol has failed to understand the objectives of the reporting framework.

1.2 Depreciation and regulatory depreciation

Also, on p9 of the discussion paper, McGrathNicol asserts that "*depreciation is likely to be a reasonable approximation of capital maintenance expenditure required by businesses. Analysis of returns before depreciation expense could overstate financial performance measures…*"[2]

This highlights APA's concerns with measuring performance as reported in statutory accounts against the allowed financial outcomes in the regulatory determination.

For statutory reporting purposes, depreciation represents the systematic allocation of an asset's cost over its service life, based on globally accepted accounting standards. This is usually undertaken on a straight line basis, where an equal portion of an asset's cost is depreciated each year of its economic life.

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[1] McGrathNicol, p6.

[2] McGrathNicol, p9.

However, the AER's regulatory regime "back-ends" depreciation by indexing the capital base for inflation, and reducing the allowed revenue requirement by the amount of the indexation. This impact is most profound where the depreciation rate applicable to long-lived assets is lower than the prevailing inflation rate – in this circumstance, regulatory depreciation will be negative.

A performance measure based on statutory accounting depreciation will consistently mis-report performance against regulatory outcomes, due to the impacts of:

- The annual amount of indexation deducted from the amount of straight line depreciation in determining the annual revenue requirement; and
- The cumulative impact of the indexation on the nominal value of the asset base over time, and the consequential impact on depreciation expense.

1.3 Clear calculation methodology

APA considers that there is scope for confusion of the calculation methodology for the relevant profitability measure as it is not clearly specified. APA considers that this methodology should be clearly set out in the PTRM in calculating the forecast measures so that users can replicate the calculation with subsequent years' actual data.

Importantly, as discussed throughout this submission, the calculation methodology must adjust earned revenues to segregate the impact of revenues on unregulated activities, and earnings related to performance against incentive mechanisms.

2 Choice of measures

The McGrathNicol report identifies a number of profitability measures, based on the application of a number of selection criteria.

2.1 McGrathNicol assessment criteria

Question:

2. Do you agree the five assessment criteria used by McGrathNicol to assess the profitability measures are appropriate? If not, what alternative criteria should be used?

McGrathNicol identifies the following assessment criteria:

- Criterion 1 - requirements are based on clear concepts and performance measures are able to be calculated consistently over time.
- Criterion 2 - calculation does not require significant manipulation of data, or require assumptions to be made. The measure's calculation is not significantly impacted by accounting adjustments, taxation treatments, or the entity's financing structure.
- Criterion 3 - generally accepted by industry experts as a good measure of profitability, and easily understood and meaningful to persons without a financial background.
- Criterion 4 - suitable given the industry characteristics (e.g. capital intensive, long life assets, regulated revenue and returns).
- Criterion 5 - readily able to be compared to other businesses in the sector and other businesses in the broader economy.

For the most part, APA accepts these as reasonable criteria when considered at a high level. However, APA is concerned with the perspective from which these criteria have been derived.

In particular, McGrathNicol appears to have developed these criteria from the perspective of a stand-alone business which prepares audited financial statements under the Australian Accounting Standards, using the concepts of asset valuation, cost, revenue and expense as would be consistent with those standards. This appears particularly in the context of Criterion 5, which

presumes a level of easy comparability between regulatory financial information and statutory financial statements prepared under the Australian Accounting Standards. However, regulatory financial reporting would be expected to raise significant comparability difficulties with financial statements prepared under the Australian Accounting Standards. This will seriously undermine the viability of Criterion 5.

McGrathNicol identifies this issue in another of its selection Criteria:[3]

> *Criterion 2 - calculation does not require significant manipulation of data, or require assumptions to be made. The measure's calculation is not significantly impacted by accounting adjustments, taxation treatments, or the entity's financing structure.*

APA considers that any measure that applies statutory accounting information is likely to fail on this criterion. In particular, one of the first steps in regulatory accounting is to "sweep out" the statutory asset values and replace them with the regulatory asset values. The primary reason for this is that regulatory asset values, on which regulatory determinations are based, have historically been determined on a basis that differs from Australian Accounting Standards.[4] The treatment of indexation and regulatory depreciation are also key differences.

This criterion will also fail where the reporting entity is part of a larger corporate group that raises capital at the corporate level. For statutory accounting purposes, the reporting entity at the service provider level may not hold any capital per se, but rather $1 of equity and the balance as a shareholder or inter-company loan.

For regulatory accounting purposes, regulated businesses will apply the regulatory asset values, capital structure and allowed cost of debt from the relevant regulatory determination. Significant manipulation of data or adjustments would be required to translate regulatory financial information to any meaningful form of Australian Accounting Standard information.

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[3] McGrathNicol, p7.

[4] One example might be where a business has been acquired – the regulatory asset value will not change, but the statutory asset value may be adjusted to reflect the acquisition cost.

This criterion in particular will cause a number of the proposed measures to be problematic to apply in practice, and will cause them to deliver spurious results.

APA considers that, in an incentive-based regulatory regime, it is important for any profitability measure to be able to segregate the impact of a regulated business' responses to the incentives inherent in the regime to ensure that this is not interpreted as economic rent or "excess profit". This key element of the regulatory framework does not feature in any of McGrathNicol's assessment criteria.

2.2 Preferred profitability measures

Question:

1. Do you agree with the preferred profitability measures? If not, what other measures do you consider should be reported by the AER and why?

APA considers that the selection of profitability measures is undermined by the misapplication of the selection criteria applied, as discussed above, and the disregard afforded to the outworkings of incentive mechanisms.

2.2.1 Return on Assets (EBIT)

APA considers that, so long as this measure is calculated using the Regulatory Asset Base as the measure of "assets", this should essentially translate to the pre-tax WACC. It would be reasonable to expect that users, and the regulator, would want to compare the earned return against the regulatory allowance.

In order to be meaningful, it would be necessary to deconstruct the earned revenues to report the effect of incentive mechanisms (the EBSS, opex and volume outperformance, etc).

As discussed above, this would need to be calculated as a comparison of the forecast vs actual amount, with the forecast measure, and the calculation methodology, reported in the PTRM.

2.2.2 *Return on Assets (net profit after tax)*

APA considers that any performance measure that introduces an element of tax is bound to result in confusion.

The main reasons for this is are twofold:

- for those entities, such as APA, which lodge tax returns at a corporate level, the allocation of tax to operating entities is fraught with difficulty;[5] and
- the calculation of tax for an operating business, whether in its financial reporting or in its tax return, does not reflect the impact of imputation credits, whereas the regulatory tax allowance does.

APA considers that no measure requiring after-tax reporting should be included among the profitability reporting metrics.

As with any proposed measure, APA considers that it is important that the forecast measure (and the calculation methodology) should be included in the AER's PTRM. The reporting should then focus on the difference between the forecast (ie AER-allowed) measure and the achieved measure after removing the impact of incentives.

2.2.3 *Return on Equity*

As discussed above, any measure including "equity" will be problematic for consolidated businesses which raise capital at the corporate level.[6] In order for this measure to be meaningful, "equity" would need to be defined in the same terms as that on which the AER's regulatory determination was based– that is, 40% of the value of the regulatory capital base.

Further, in order to derive a meaningful measure, debt and interest would similarly need to be based on the allowed levels of debt and interest rather than some form of allocated interest from the corporate entity.

[5] For example, the current amount of tax depreciation for a particular asset may be affected by historical investment tax incentives.

[6] This will similarly apply to any measure calculated on a "per share" basis.

2.2.4 *Economic Profit*

APA is concerned about the introduction of this measure, as it is an inaccurate and emotive term.

Importantly, it will be necessary to establish a context against which this measure can be compared. For example, if a business' earnings differ from that which would be anticipated given its AER-allowed return, the extent of that difference must be interpreted in the context of the size of the business. A given dollar amount of "economic profit" (as defined in the context of this proposal) might be notable for a small business, but might be within the realm of forecasting error for a larger business.

If this measure is to be reported, it is critical that amounts earned through the business' unregulated revenue, or revenues earned through responding to incentives (a positive outcome) are not negatively characterised as "economic profit".

2.2.5 *Operating profit per customer/connection*

APA is not clear as to what the AER is seeking to report with this measure, or what behaviour would be encouraged by shippers based on the level of this measure.

Gas transmission businesses, by their nature, are characterised by very few "connections", being primarily producers and vendors or gas, large industrial customers, power stations or distribution networks. Its "customers" include retailers, who may take service at a number of distribution network city gate stations and delivery points associated with industrial users.

For a distribution business with a large number of customers, the impact of a given dollar amount of operating profit will be diluted by the large number of customers. Once so diluted, the difference between the forecast and outturn measures is likely to be so small as to fail to elicit a response from users.

In summary, APA considers that Return on Assets (EBIT) is the only proposed measure that will allow users to compare outcomes against the forecasts in the AER's regulatory determination.

3 Information requirements

Question:

3. Do you agree that the identified data is required to develop the preferred profitability measures?

In this submission, APA submits that Return on Assets (EBIT) is the only proposed measure that will allow users to compare outcomes against the forecasts in the AER's regulatory determination.

For this measure, the AER proposes that the businesses should report

- Earnings before interest and tax (EBIT); and
- Regulated Asset Base (RAB)

APA accepts that this reporting is required to support this profitability measure. However, the EBIT measure should be reported to exclude unregulated revenue, and after giving effect to the impact of the incentive mechanism relevant to the regime. APA therefore submits that the required reporting should be:

- Earnings before interest and tax (EBIT) *after reflecting the effect of incentive mechanisms*; and
- Regulated Asset Base (RAB)

In this respect, "incentive mechanisms" must be defined to include not just the AER's specified incentive mechanisms such as the EBSS and STPIS, but more importantly the incentive mechanisms inherent in the regime. This would include the regimes incentives to reduce costs and, in a price cap regime, to increase utilisation.

APA considers that this value will then be comparable to the pre-tax WACC allowed in the AER's regulatory determination.

Question:

4. If you consider other profitability measures should be reported, what data is required to support those measures?

APA does not consider that any other profitability measures should be reported.

3.1 Measures and data

Question:

5. Do you consider we should use the same measures and data for all regulated businesses, or should we adopt different measures for different sectors (electricity / gas) or different segments (distribution / transmission) of the energy sector?

APA is always concerned about assuming that a one-size-fits-all regulatory regime is appropriate for all businesses.

In the context of this consultation, the key difference will be whether the business is regulated under a price cap or revenue cap regime, and the differing incentives under these two regimes.

In particular, under a revenue cap regime, the regulated business is incentivised to control or reduce its costs, but has no incentive to sell more of its services.[7] In sharp contrast, while a business regulated under a price cap regime equally has incentives to reduce its costs, it also has significant incentives to increase the volume of services provided. This is a feature of the regulatory regime.

This is critically important in order for the profitability reporting regime to maintain its integrity. As discussed above, it will be important for reported earnings to differentiate revenues earned through the application of incentive regimes in order to derive a meaningful comparison with the regulatory determination's forecast outcomes.

[7] It is not at all clear what role profitability reporting could reasonably play for a business regulated under a revenue cap, when any under- or over-earnings are attributed back to customers through the tariff mechanism.

Question:

6. In addition to profitability measures, should we report other measures of financial performance? If so, how would these other measures contribute to the achievement of the NEO or NGO?

APA considers that the purpose of the profitability reporting regime is to monitor performance against the forecasts inherent in the most recent regulatory determination and inform the AER's next regulatory review. It is in these review processes that the AER will reach regulatory decisions that will aim to promote the National Gas Objective.

In this regard, APA considers that a more relevant measure might be achieved WACC (after accounting for the effect of incentive mechanisms) relative to the allowed WACC. This will allow direct comparison to the AER's determination outcomes. APA notes that this boils down to the Return on Assets (EBIT) discussed above.

In APA's view, no further financial performance measures are required.

3.2 Audit requirements

McGrathNicol recommends, on page 40 of its report to the AER, that the AER should:[8]

> *Require businesses to prepare audited financial statements in accordance with the Australian Accounting Standards, and require that statutory figures in the annual reporting RIN agree to financial statements prepared in accordance with the standards.*

The question of "audit"[9] requirements has been discussed extensively in the context of the GMRG's consultation on the Financial Reporting Guideline for non-scheme pipelines. What has become clear through that consultation process is that it is not clearly within McGrathNicol's expertise to advise on what matters can and cannot be "audited" and the costs that may be incurred in conducting those "audits".

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[8] McGrathNicol, p40

[9] Here the term "audit" is used loosely to encompass positive assurance audit reporting vs negative assurance review reporting and the performance of agreed upon procedures.

It is also important to consider whether it is reasonable to expect regulated businesses to prepare financial statements in accordance with the Australian Accounting Standards when indeed the profitability measures to be reported will be based on a different foundation. For example:

- Australian Accounting Standards do not provide for indexation of assets for inflation, whereas the regulatory framework is based on indexed regulatory asset values;
- Where an asset has been acquired, the Australian Accounting Standards would provide for the acquired asset to be reported at its acquisition cost. In contrast, the regulatory asset value does not change in the event of a change in ownership.

The AER discussion paper identifies that gas pipeline companies generally do not report financial information between regulatory resets. As discussed above, APA considers that ongoing monitoring is a reasonable component of an economic regulatory regime. However, as also outlined above, it is important to ensure that the performance reporting and data gathering are responsive to the relevant regimes, and do not impose reporting burdens that do not promote the objectives of the regime.

In this context, APA questions the need for businesses to report a complete balance sheet. As discussed above, many pipeline businesses are owned in a corporate structure under which capital is raised at, and allocated from, the corporate or parent level. The balance sheet of the reporting business would therefore not reflect the benchmark capitalisation reflected in the regulatory framework, but could potentially reflect a very small amount of equity and the balance of capitalisation being made up of intercompany allocations of capital.

A balance sheet for such a business would need to be constructed based on assumptions of reasonable levels of debt and equity for such a business. Since these already form part of the regulator's determination, it seems reasonable to simply use the regulatory benchmarks for capital structure, cost of debt and cost of equity.

APA submits that a requirement for the business to prepare stand-alone financial statements in accordance with the Australian Accounting Standards will not serve to promote the National Gas Objective.

APA understands through the GMRG consultation process that the GMRG accepts this point, and is proposing to remove its intended requirement for non-scheme pipelines to report a balance sheet, preferring instead to report measures of return on total assets in lieu. For a regulated pipeline (the subject of this consultation), this would allow direct comparison to the outcomes of the relevant regulatory determination.