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8 December 2017

Ms Kaye Johnston
Director, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Kaye

Re: Profitability measures for regulated network businesses - Discussion Paper

AusNet Electricity Services Pty Ltd (**AusNet Services**) welcomes the opportunity to make a submission in response to the Australian Energy Regulator's (**AER**) Discussion Paper on profitability measures for regulated gas and electricity network businesses.

The introduction of profitability reporting may improve transparency to stakeholders in respect of the financial returns earned by regulated networks, and address concerns that have been raised by some stakeholders in respect of excessive profitability of regulated network service providers.

However, we caution the AER that meaningful comparisons may be limited by the nature of the profitability measures, the unique features of the regulatory framework (e.g. the impact of incentive schemes) and cost allocation assumptions that are required to prepare financial statements at the regulated network level.

For example, if required to report net profit after tax (NPAT), businesses will need to make a range of assumptions (e.g. allocate interest and tax costs to the regulated network level) that will limit the relevance and usefulness of the measures. Costs will also be incurred to produce and have audited the financial statements required to produce NPAT level data, which are ultimately borne by customers. These costs should be weighed carefully against the benefits of the reported data, given its limited relevance.

For these reasons, profitability reporting should be limited to metrics that are the most meaningful, comparable with regulatory allowances and not impacted by differences in capital and tax structures. For example, the reporting of EBIT (earnings before interest and tax) is not affected by the allocation issues identified above, making it a more appropriate measure.

Notwithstanding this, the usefulness of even the most meaningful metrics may be limited. Accordingly, the purpose for which the AER intends to use any new profitability data should be clearly defined. Understanding this would aid stakeholders in providing further feedback on what the most appropriate metrics may be.

AusNet Services supports the submission made by Energy Networks Australia to the Discussion Paper.

Further discussion of the issues identified above is provided in Attachment 1, which sets out our responses to the questions posed in the Discussion Paper. If you have any queries in relation to this submission, please contact Rob Ball, Senior Economist on 03 9695 6281.

Sincerely,

Tom Hallam
General Manager – Regulation and Network Strategy

Attachment 1: Detailed responses to Discussion Paper questions

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?

The AER's preferred profitability measure is return on assets (EBIT/RAB or total assets). The AER also identified the following measures as preferred, despite their limitations:

- Return on equity (NPAT/total equity);
- Operating profit per customer/connection (EBIT / total customers); and
- Economic profit (EBIT – pre-tax WACC * total assets or RAB).

AusNet Services considers the AER's preferred profitability measures that rely on EBIT data, in particular the return on assets measure, to be the most meaningful. We consider this measure should be calculated as EBIT/RAB, rather than EBIT/total assets (discussed further below in response to question 3). As recognised by McGrathNicol, an EBIT-based measures reflects operational performance and is unaffected by corporate and tax structures. Additionally, this approach is less impacted by accounting policy choice, than metrics which rely on balance sheet measures.

In contrast, return on equity and other NPAT-based measures are impacted by gearing and tax and ownership structures, as the AER has noted. NPAT-based measures will not provide meaningful comparisons between regulated networks, given the diversity in Australian network ownership. Return on equity (NPAT) comparison between businesses will also be problematic due to differences in gearing levels, which will lead to markedly different return on equity outcomes being reported for businesses whose underlying profitability may be similar.

Furthermore, differences in risk profile will not be appropriately reflected in NPAT measures. While a business could achieve high levels of short-term probability through the use of high gearing and short-term bank debt, this risk appetite could result in the business not being financially sustainable, despite its apparent strong profitability. Accordingly, there is a danger that using NPAT profitability for comparisons will lead to misleading conclusions about the relative profitability of businesses, without taking into account risks.

While preferable to NPAT-based measures, EBIT-based measures are not without issue. For example, EBIT is affected by the impacts of service standard and expenditure efficiency incentive schemes. These schemes are central and non-controversial planks of the current regulatory regime, the outperformance of which promotes the long term interests of consumers (e.g. through lower future expenditures, or improved service standards). In many cases, higher earnings will be because of better customer outcomes, now or in the future.

The timing of regulatory decisions, insofar as different WACC parameters are applied across businesses, may also affect earnings comparisons. These differences may be material, due to movements in the risk free rate, as well as differences in the parameters prescribed in the Rate of Return Guideline prevailing at the time different regulatory determinations are made.

Accordingly, the extent to which reported earnings are impacted by the unique features of the regulatory regime should be recognised when interpreting regulated networks' reported profitability.

Furthermore, should the AER introduce new profitability reporting, its regulatory determinations should produce a "benchmark" measure of the same metrics, to ensure like-for-like comparisons are made with the reported data, and to provide further clarity to both networks and stakeholders as to the purpose of the profitability metrics. We note there is a risk that, even with benchmark measures, the complexity of some profitability metrics means they will be prone to misinterpretation by stakeholders.

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?

The assessment criteria used by McGrathNicol appear appropriate and reasonable.

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

The data required to develop the most meaningful profitability measure – EBIT/RAB – is currently largely available through existing RIN reporting. Accordingly, minimal change is needed to existing reporting arrangements in order to implement meaningful profitability reporting.

AusNet Services considers that any new reporting requirements should be tailored to facilitate the reporting of only the most meaningful and relevant measures. This is preferable to the wholesale introduction of financial statement reporting at the regulated network level. This approach balances minimising the cost of regulatory reporting, which is ultimately borne by customers, with the objective of improving transparency. While McGrathNicol identified financial statements as data the AER may wish to start requesting, positively the Discussion Paper does not appear to be proposing this approach.

As noted above, we agree that the reporting of some balance sheet and income statement data (i.e. annual RAB and earnings data) is needed to calculate return on assets (EBIT/RAB). However, we consider that the data needed to calculate NPAT-based metrics (e.g. interest and tax expenses) should not be added to annual reporting requirements, nor should businesses be required to produce full financial statements of a comparable nature to their statutory accounts.

As previously discussed, calculating NPAT requires the allocation of interest and tax expenses to the regulated network level. Similarly, profitability measures involving Total Assets and Total Liabilities require the creation of balance sheets by service classification. These balances and transactions are incurred and accounted for at a company level, and disaggregation into service classifications is not captured in AusNet Services' existing processes or systems. Therefore, producing this data would require the development of a range of assumptions that may differ between businesses, both increasing regulatory burden and resulting in reported data that may not be comparable with other businesses and regulatory benchmarks.

Additionally, balance sheet balances are impacted by each business' choice of accounting policies, which may also impact comparability, not just between network businesses but also over time for the same business. For example, total assets and total liabilities are subject to short-term variability for various reasons (e.g. working capital management, mark-to-market movements for balances recognised at fair value). Accordingly, AusNet Services believes that any profitability measure requiring a measure of assets should be based on RAB, as opposed to an accounting balance sheet.

Finally, if the AER proceeds with this initiative, AusNet Services encourages it to take the opportunity to rationalise the existing benchmarking RINs and remove any redundant data. This would help to offset any additional regulatory burden created by profitability reporting requirements and, ideally, result in neutral reporting costs overall.

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

We do not see any benefit in reporting other profitability measures.

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?

Because industry characteristics and regulatory frameworks are, at a high level, similar across all sectors/segments, we consider that the same EBIT-based metrics can be used for each sector and segment.

However, due to differences between sectors and segments (e.g. higher capital intensity of transmission, less operations and maintenance expenditure on gas networks due to their underground assets) we consider the most robust comparisons will be between businesses within the same sector or segment. Some metrics may also be meaningless for comparisons across all regulated businesses, such as operating profit per customer comparisons between transmission and distribution networks.

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?

At this stage, AusNet Services does not support the introduction of other financial performance measures, e.g. liquidity or financing ratios. As the AER has recognised, these measures do not provide a measure of profitability, and it is not clear what purpose their reporting would serve in terms of allowing the AER to better carry out its regulatory functions, improving transparency or addressing concerns raised by stakeholders. It is also not clear how the reporting of these other measures would contribute to the achievement of the NEO or NGO.

Nonetheless, we recognise that the need for the reporting of other financial performance measures (e.g. financeability metrics) may evolve over time.