Consumer
Challenge
Panel

Submission to the Australian Energy Regulator (AER)

Consumer Challenge Panel

Submission to the AER on its Profitability Measures Position Paper

Sub-Panel 18

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Table of Contents

1. Introduction and Summary 4
1.1 Executive Summary 5
2 Summary of CCP 18 Submission to the AER Discussion Paper 7
3 AER Position Paper and CCP 18 Response 8
3.1 Purpose of profitability measures 8
3.2 Proposed Profitability Measures and Comparisons 10
3.3 Can profits of regulated businesses be compared to profits of unregulated businesses? ... 12
3.4 Use of Profitability Measures 13
3.4.1 Use of RAB Multiples 14
3.4.2 Use of averages over time and NSPs 17
4 Issues in specification and implementation of profitability measures 17
4.1 Comparisons with unregulated businesses: statutory or regulatory measures 17
4.2 Asset valuation for statutory reporting 18
4.2.1 Initial asset valuation 18
4.2.2 Asset revaluation on acquisition 21
4.3 Adjustments for unregulated activities 22
4.4 Adjustments for incentive schemes 23
4.5 Cost Allocation in calculating ROE 24
4.6 Annual Reporting 25

Acronyms

AER	Australian Energy Regulator
ARORO	Allowed Rate of Return Objective
Capex	Capital expenditure
CCP	Consumer Challenge Panel
CCP 18	Consumer Challenge Sub-Panel 18
EBIT	Earnings before interest and tax
NEL	National Electricity Law
NER	National Electricity Rules
NGL	National Gas Law
NPAT	Net Profit after Tax
NSP	Network Service Provider
Opex	Operating expenditure
RAB	Regulatory Asset Base
ROE	Return on equity
ROR	Rate of return
WACC	Weighted Average Cost of Capital

1. Introduction and Summary

The AER established the Consumer Challenge Panel (CCP) in July 2013 as part of its Better Regulation reforms. These reforms aimed to deliver an improved regulatory framework focused on the long-term interests of consumers.

The CCP assists the AER in making better regulatory determinations by providing input on issues of importance to consumers. The expert members of the CCP bring consumer perspectives to the attention of the AER to better balance the range of views considered as part of the AER's decisions.[1]

On 8 November 2017, the AER released a discussion paper on "Profitability measures for regulated gas and electricity network business" and an accompanying consultant's report by McGrathNicol and CCP 18 (a sub-panel of the CCP) provided a submission to the review. Following consideration of submissions, the AER released a draft position paper and accompanying response to submissions by McGrathNicol on 27 April.

CCP 18 is pleased to see that the AER has recognised the need to respond to consumers very deep concerns that from their perspective the current regulatory framework has failed to deliver affordable network services to consumers, particularly following the massive increase in network prices over the period 2009-2014. When consumers see networks being sold for RAB multiples of 1.4 or more, adding significantly to the profits of the owners; when they read annual reports that reveal continual growth in CAGR compared to the ASX average, they are right to challenge the regulatory process.

The review of profitability measures is occurring concurrently with important reviews of the ROR and tax allowances that are also important for ensuring regulation is transparent, efficient and balanced. By balanced we mean that it should provide the opportunity for efficient NSPs to earn a commercial return while ensuring customers pay no more than necessary. This is central to the long term interest of consumers which underpins the NEO and NGO.

As we stated in our earlier submission, transparency is part of the social contract that comes with the protections of a monopoly service from competition, and essential for the legitimacy and credibility of the regulatory regime. Measuring profits is part of good regulatory practice as an indicator of the overall outcomes of the regulatory regime and the extent to which it is meeting the expectations of all stakeholders.

In this context we appreciate the ENA's expression of support for the development and implementation of profitability measures and acknowledgement that this is an opportunity to promote improved confidence and stability in the regulatory regime[2]. We do not see this review, or those on tax and the ROR, as a 'threat' to the security of supply as some NSPs have asserted.

This submission responds to the AER's Position Paper and is structured as follows:

- Section 2 provides a summary of the CCP 18 submission to the AER Discussion Paper on profitability measures.

[1] Detailed information on the CCP is available on the AER website at https://www.aer.gov.au/about-us/consumer-challenge-panel

[2] ENA presentation, Public Forum on Profitability Measures, 16 May 2018.

- Section 3 summarises the AER's proposed positions and the CCP 18's responses

- Section 4 discusses implementation issues in regard to the specification of comparable measures, the use of the measures in the assessment of the ROR, and the data collection and auditing requirements.

1.1 Executive Summary

CCP 18 strongly supports the positions set out in the AER's draft position paper, with some amendments and extensions, as set out in the table below.

Profitability measures provide an aggregate (or rolled-up) measure of the performance of the regulatory system. As an aggregate measure, many factors can affect the outcomes. This does not diminish the value of these measures, but it highlights the need for the measures to be supported by analysis of these factors and the reasons for the outcomes. The analysis may provide assurance that the regulatory regime is providing the opportunity for the utilities to earn a commercial, but not excessive, return. Or it may lead to changes that will enable the regulatory regime to better fulfil this objective.

In analysing profitability measures the AER should focus on:

- results across NSPs rather than results for individual NSPs
- results over the medium to long term rather than annual variations.

We support the profitability measures and comparisons proposed by the AER in its position paper. The measures proposed are a coherent set of measures that:

- are consistent with the criteria established (as amended following consideration of comments from stakeholders, including CCP 18)
- have regard to the problems of comparisons with regulated and unregulated businesses
- are practical, well-accepted and widely-used measures of profitability.

CCP 18 is very conscious of the inevitable imperfections in any practical profitability measure and comparison. This means that care and judgement must be exercised in using the measures and comparisons. We do not accept the argument of some stakeholders that profitability of regulated businesses cannot be compared with unregulated businesses. Accounting principles provide a basis for the assessment and comparison of the profitability of disparate businesses operating in different market environments, including regulated businesses. Hence, we support the AER's proposal to require the regulated businesses to report on a statutory basis.

Asset valuation will be a key issue in the preparation of financial statements on a statutory basis. Depreciated historic cost would be the preferred basis as this would be more comparable with other businesses in the broader economy who mostly do not revalue assets. However, we accept that this may not be feasible for establishing the initial asset base and that the only feasible option is the RAB on entry to regulation under the national energy rules. Comparability with businesses in the broader economy will be enhanced if assets are not revalued in subsequent periods for statutory reporting. If revaluation is allowed on acquisition profitability measures should also be calculated exclusive of the impact of revaluation.

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Table 1: Summary of Response to AER's Draft Position Paper

Position Paper Proposal	Response
Purpose: Transparency; assess performance of regulation	**Supported**: assessment must be translated into decisions (eg ROR)
Multiple measures to be used	**Supported** – different measures provide additional insights
Basis of measures: Statutory and regulatory	**Supported –** improves comparability, understanding of variations
Proposed measures: 1) Return on Assets (statutory and regulatory) 2) Return on Equity (statutory and regulatory) 3) Earnings per customer/connection 4) RAB multiples	**Supported** subject to: 1) clarification of initial RAB in statutory accounts 2) requirement to analyse factors behind RAB multiples and trends in profitability measures 3) use of RAB multiples as a directional indicator for ROR
Data collection: 1) New data requirements for statutory accounts (with allocation rules) 2) Statutory accounts to be audited	**Supported** 1) Data requirements are reasonable and will add value 2) Rules on allocations should be mandatory, ensure comparability
Reporting: 1) Annual performance report to be published 2) NSPs can provide comments on draft report	**Supported** with extensions 1) Annual report must analyse and interpret results 2) Other stakeholders to comment on draft

In principle, revenue from incentive schemes should be included in comparisons of profitability with unregulated businesses as the objective is to assess the overall outcomes of the regulatory regime with market outcomes. We would expect that the comparison of the measured profitability would examine the reasons for this, including whether revenues from incentive schemes are a significant factor. Revenue from incentive schemes will need to be separated-out in using profitability measures to inform decisions on the allowed ROR. However, the expected revenues from incentives schemes would need to be factored into cash flows if they are significant and persistently positive or negative across NSPs.

CCP 18 endorses McGrathNicol's conclusion that, with guidance, debt and tax costs can reasonably be allocated between regulated and unregulated businesses. We recommend that the AER specify the allocation rules to be used to strengthen the comparability of the profitability measures and reduce costs. The rules suggested by McGrathNicol provide a sound basis for the development of more detailed allocation rules. Most of the listed network companies already report profitability by segment to their shareholders and this should facilitate the allocation tasks.

CCP 18 supports annual reporting of profitability measures by the AER. It is important that the annual report looks beyond the headline numbers to an analysis of possible reasons for trends and variations. Stakeholders other than the NSPs should also be able to provide comments on the draft report and claims for confidentiality must be closely scrutinised. There should be a presumption that financial performance data on regulated NSPs should be in the public domain irrespective of ownership of the company and its location in our outside Australia. It should be clear to the networks

that transparency is part of the social contract that comes with the protections of a monopoly service from competition.

2 Summary of CCP 18 Submission to the AER Discussion Paper

This section summarises CCP 18's earlier submission on the AER Discussion paper to provide context for this submission to the Position Paper and reduce repetition. The reader is referred to the submission for further detail on the supporting analysis and arguments.

Consumers understand that the utilities should have the opportunity to earn a profit commensurate with the businesses' risks, but they expect the regulator will ensure utilities do not earn a monopoly profit. Comparisons of profitability can help provide assurance on this, strengthening two of the fundamental principles for sustainable regulation – legitimacy and transparency. Without this, confidence in the regulatory regime will be eroded, and the pressure to change will be irresistible.

Therefore, we supported the AER's exploration of profitability measures. Actual opex and capex of the network and its peers are considered in assessing efficient opex and capex. Comparing actual profits to allowances and the profits of peers would make the treatment of the return component of the building blocks more comparable to the treatment of opex and capex. This could also be extended to debt costs and tax, but this is outside the scope of the current review.[3]

Consumer groups and the CCP have previously questioned the level of profitability of the regulated businesses and have sought to undertake their own comparisons of profitability. The concern was that the approach to determining the rate of return (ROR) and overall revenue may have consistently resulted in profits for the regulated networks that were higher than those of comparable unregulated businesses and higher than investors' required returns. This can be due to many factors including lower opex/capex, tax payments, or debt costs compared to the regulatory allowances.

While it is not unusual for a regulator to 'aim high' on the cost of capital, this may have been exacerbated in Australia by interpretations of the NEL/NGL and ARORO which emphasised the environment for investment rather than a more balanced view of the long-term interest of consumers. "Aiming high" on the WACC can create an incentive to overinvest by providing a return that exceeds the return required by the investors[4]. In other jurisdictions, the risk of exclusion of past capex considered inefficient reduces this, but the risk of exclusion of past capex is very small in practice in Australia for electricity networks.[5] This adds to the costs of aiming high and reduces the need to do so.

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[3] Subsequently the AER has issued a discussion paper on debt (an accompanying paper by its consultant, Chairmont) and commenced a review of the treatment of tax that will provide an opportunity to further explore these issues. See AER Discussion paper - Review of the rate of return guideline - Estimating the allowed return on debt - May 2018, and Chairmont - Aggregation of Return on Debt Data report - 28 April 2018.

[4] The recent report by the Grattan Institute has highlighted the costs to consumers of overinvestment and the growth in the RAB see "Down to the wire: A sustainable electricity network for Australia" 25 March 2018 https://grattan.edu.au/report/down-to-the-wire/

[5] The efficiency of capex can only be examined prior to inclusion in the RAB if total capex spend exceeds the allowed capex spending and once in the RAB assets are not subject to optimisation in future reviews.

Profitability measures should be used as a cross-check on the determination of the Rate of Return[6] (ROR) and the overall revenue requirements for the energy networks.

Profitability measures can help address three questions:

1. Are actual returns higher than allowed?
2. Are actual returns higher than in comparable businesses (regulated and unregulated)?
3. Is the allowed return higher than the investors' expectations?

Comparisons of profitability will need to be considered carefully and cannot be used mechanically. All measures of profitability are likely to be imperfect in some way and better suited for some purposes than others. Consequently, it will be necessary to consider a range of measures. Some measures will be given more weight for some purposes, but less weight for other purposes.

The McGrath Nicol report recommended the use of Return on Assets (EBIT) as the primary measure supplemented by:

1. Return on Equity (net profit after tax/equity),
2. Operating profit per customer,
3. Economic profit (EBIT – pre-tax WACC*RAB).

The CCP 18 submission supported the proposed profitability measures but proposed that the set of measures be expanded to include RAB multiples (i.e. Market Value/RAB ratios). It also noted that economic profit measures duplicated the comparison of the return on assets with allowed WACC.

EBIT/RAB is a simple, well-recognised, and widely used profitability measure that can be used to compare profitability with allowed ROR and the profitability of other businesses regulated by the AER. However, comparisons with unregulated businesses will need to consider the differences in asset valuation and reporting of income between the regulated and unregulated businesses. These comparisons need to take into account the capital gain from asset indexation that forms part of the return to the owner of the regulated businesses.

Market Value/RAB ('RAB multiple')is also a simple measure that is widely used by investors and regulators. For regulators, it can provide an indication of the relativity of the allowed ROR and investors required ROR. Hence, it can be used as a cross-check on the ROR proposed but it requires:

1. further analysis to 'peel away' the additional sources of value,
2. consideration of multiple observations to identify if there is a systematic pattern for RAB multiples significantly larger than 1.

3 AER Position Paper and CCP 18 Response

3.1 Purpose of profitability measures

Under the 'Objective of the Review' the AER explains that it is seeking measures that will "allow comparison of:

- expected returns of a service provider to its actual returns

[6] The terms ROR and Weighted Average cost of Capital (WACC) are used interchangeably.

- returns between service providers in the same sector
- returns between the service providers and other regulated/unregulated industries.

… [to enhance transparency and provide] an additional source of information with which to review the overall effectiveness of the overall effectiveness of the regulatory regime.”[7]

The proposed comparisons are supported and will directly assist in the assessment of the effectiveness of the regulatory regime (see table below), but we would also include comparisons of the investors expected returns and allowed returns. The latter requires forward looking measures of profitability – such as RAB multiples – but is more directly relevant to the determination of an appropriate ROR by the AER.

Table 2: The Role of Comparisons of Profitability Measures

Proposed Comparison	Use
Expected (allowed?) returns compared to actual returns	Identifies extent and basis for differences – e.g. opex and capex efficiency (or forecast errors), performance incentive payments, variations between allowed tax and debt costs and actual tax and debt costs. Informs assessment of regulatory framework; e.g is it encouraging efficiency, are the incentive payments balanced, are the cost forecasts biased?
Returns between providers in the same sector	Supplements comparisons above by testing whether the differences in returns between NSPs are large and systematic (e.g. vary by size, sector, or ownership).
Returns between service providers and other regulated and unregulated businesses	Identifies the extent to which returns of regulated NSPs are comparable to either regulated businesses in other sectors/jurisdictions or unregulated businesses (having regard to risk and capital intensity). This can inform ROR and assessment of regulatory framework.
Comparison of expected and allowed returns	Provides guidance on whether expected returns of investors in NSPs are above or below the allowed return. If systematic and sustained, variations in expected and allowed returns affect investment incentives and signal economic losses[8] or rents. This can inform ROR and assessment of regulatory framework

While it may be implied by the reference to profitability measures assisting the review of the overall effectiveness of the regulatory regime it is critical that this is translated into action where necessary. For example, if profitability measures indicate that:

- allowed returns exceed investors’ expected required returns, and/or

[7] AER, Profitability measures for electricity and gas network businesses: Draft position paper, April 2018, p2.
[8] Economic losses occur if returns are below the risk- adjusted normal return.

- actual returns for NSPs have been significantly higher than returns for comparable unregulated businesses

there should be a clear traceable link to actions to reduce these discrepancies.

3.2 Proposed Profitability Measures and Comparisons

In its Position Paper the AER has expanded the number profitability measures proposed to better answer the questions posed and address the objectives it has set out.

Table 3: Proposed Profitability Measures

Proposed Measure	Calculation
Return on Assets (Regulatory)	Regulatory EBIT / 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/connections, where Regulatory EBIT and customer/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 Position Paper, p3.

The CCP 18 supports the proposed measures as they provide a coherent set of measures that:

- are consistent with the criteria established (as amended following consideration of comments from stakeholders, including the CCP 18)
- have regard to the problems of comparisons with regulated and unregulated businesses
- are practical, well-accepted and widely-used measures of profitability

In making this assessment the CCP 18 is very conscious of the inevitable imperfections in any practical profitability measure and comparison. This means that care and judgement must be exercised in using the measures and comparisons. Furthermore, a search for perfect measures of profitability imposes a higher standard for profitability measures than other models and information used in practice in the regulation of the NSPs. For example, the inherent limitations and imperfections of other information used in assessing the rate of return and efficient opex and capex benchmarks are well recognised. A search for perfect measures can lead to measures that have significant but imperfect information content being set aside to the detriment of sound regulatory decisions.

The key changes from the proposed measures in the Discussion Paper are:

1. *Removal of the distinction between primary and secondary measures of profitability*. This is supported as it broadens the measures used, facilitating the extraction of relevant

information through comparison, and reducing the weight placed on any one measure. For example, comparisons of return on assets and return on equity can highlight the effect of gearing and the difference between actual cost of debt and tax expense and the allowances for debt and tax

2. *Separation of measures of return on assets and equity into measures based regulatory information and statutory accounts*. This is supported as it facilitates consistent but separate comparisons with other regulated businesses and unregulated businesses.
3. *Inclusion of RAB multiples.* This is strongly supported. As argued in our earlier submission this is a widely used measure that provides relevant information on investor expectations on returns. The CCP 18 submission on the discussion paper provides further supporting information and analysis.
4. *Removal of economic profit.* This is supported as it duplicated the comparison of regulatory returns with the allowed WACC

The table below draws aligns the different measures to the comparisons set out in the section on objectives of profitability measures and also highlights some of the outstanding issues in these comparisons that are discussed in the following sections.

Table 4: Alignment of Objectives and Profitability Measures

Issue	Measures	Comparisons and issues
Systematic variations between actual and allowed returns? Why?	ROA (Regulatory) ROE (Regulatory)	• Comparison of actual returns and allowed ROA (grossed up for tax) and allowed ROE • Highlights causes (interest, tax, incentives)
Variation in returns between NSPs? Why?	ROA (Regulatory) ROE (Regulatory)	• As above. Can highlight extent to which issues are systemic or provider specific
Are actual returns comparable to: a) **other regulated**	ROA (Regulatory) ROE (Regulatory)	• Comparisons with other regulated businesses can highlight impact of differences in reg regimes
b) **unregulated industries (given risk level)? Why?**	ROA (Statutory) ROE (Statutory) •	• Comparisons with other business (statutory basis) provides a guide to reasonableness of outcomes. • Will require careful analysis – but essential
Are allowed returns in line with expected returns? Why?	RAB Multiples	• Benchmark ranges need to be established • Analysis required to 'peel away' sources of value and implications for regulatory decisions
Are returns increasing over time?	EBIT/customer, EBIT/ Connection	• Comparisons over time only • Shows trends in profits and impacts on users

3.3 Can profits of regulated businesses be compared to profits of unregulated businesses?

APA take the position that the profits of regulated businesses cannot be compared to the profits of unregulated business as a matter of principle and practice. The practical issues in the comparable measurement of profits in regulated and unregulated businesses are discussed below. However, the proposition that as a matter of principle the two cannot be compared must be rejected as it reflects a confusion between how revenues/prices are set and the measurement of profits available to the shareholders.

In their submission on the Discussion Paper, APA state that:

> McGrathNicol's discussion paper indicates that:
>
> *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.

Furthermore, in their presentation to the forum in May 2018 APA stated that "It is meaningless (and misleading!) to assess regulatory outcomes in a statutory reporting framework." In the forum the APA argued that because the NSPs' revenues are set on the basis of a real rate of return on an indexed asset base the profitability of the businesses can only be assessed on that basis (i.e. on a regulatory accounting basis). Hence, according to the APA, the profits of these businesses cannot be compared with other businesses whose revenues are determined through other means and which report on a statutory accounting basis.

This argument confuses the way in which revenues are determined with the basis of measurement and comparison of profits. Prices and revenues for unregulated firms can be determined in many ways. For some businesses – such as tollroads – prices set under long term contracts and are not subject to the short-term market pressures faced by other businesses who supply their products/services in highly competitive markets and have little control over pricing. In between these positions many firms can exercise a degree of market power for a period of time. Importantly, how the revenues/prices are determined does not affect their ability to report profits in accordance with accounting standards on a broadly comparable basis. Nor does it affect the ability of analysts and investors to include profitability measures when comparing the performance of firms. In accounting terms profits are the revenues available after all expenses, including the return of capital investments through depreciation. How prices for the business are determined may affect the level of revenues and profits but it does not mean that in principle profits cannot be measured and compared on a broadly comparable basis.

The way in which regulated prices/revenues are determined can affect the time-profile of revenues over the life of an asset. The potential for this effect will need to be considered in comparing profitability. It is generally accepted that over the life of an asset the NPV of revenues under the real return on an indexed asset base approach ('real-on-real'), as used by AER, will equal the NPV of revenues under an equivalent nominal return on an historic cost asset base. But the time profile of

revenues will differ, the real-on-real approach results in lower prices in the early years and higher prices in the latter years of an asset's life. If an NSP has a single primary asset this effect may be significant. However, in practice NSPs have a mix of assets of different ages significantly reducing the practical effect of this.

3.4 Use of Profitability Measures

The Position Paper states that "Profitability outcomes may also be used by us and stakeholders as an additional factor by which to monitor the overall effectiveness of the regulatory regime in achieving the national energy objectives."[9] As such, the regulators initial interest is in the overall profitability of the regulated sector rather than the profit of individual businesses, although this may in turn become important when examining the drivers of this outcome.[10]

In many ways profitability is an aggregate measure of the overall financial performance of the regulatory regime. Actual profitability is the net outcome of the actual costs and the estimated efficient costs from which the allowed revenues are built, and the efficiency and performance incentive schemes. Hence, variations in any one component flows through to overall profitability measures. To the extent there are substantial variations between actual and allowed profitability, the reasons for this need to be examined and the need for changes to the regulatory regime considered. That is, profitability measures should inform regulatory decisions.

One example is outperformance through efficiency gains. The return on assets and return on equity may be higher due to greater-than-expected efficiency improvements. If so, this indicates that the regulatory regime is performing in the long term interest of consumers ***so long the gains are not due to 'soft' forecasts of efficient costs or underinvestment in meeting the performance standards.*** Consumers can reasonably expect that the regulator will set 'tough but fair' efficiency targets reflecting the notion of a 'workably competitive market where shareholders rather than consumers bear the risk of management error.

A test of this is whether there is systematic out-performance so that the aggregate financial benefits from efficiency outperformance systematically and consistently exceed the financial losses from underperformance (but not at the detriment of meeting standards of performance). If this were to be the case, the regulator should either review its approach to forecast efficiency gains to achieve a more balance outcome, or include the expected average value of the outperformance across the DNSPs in the building block cash flows. We note that the AER has undertaken "a review of the contribution of incentive schemes to total revenue …[and] found that on average the revenue impact was minor as a percentage of total revenue."[11]

A second example is the identification of outperformance through differences between actual debt and tax costs and allowed debt and tax costs. A variation between regulatory return on assets and regulatory return on equity can highlight these differences. To the extent that the differences are systematic and sustained the regulator should review its approach to estimating the benchmark debt and tax costs – as the AER is doing.

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[9] AER, Draft Position Paper, p5.

[10] For example, are there differences in outcomes according ownership or sector (gas/electricity, transmission/distribution)? If so what is driving these?

[11] AER, Position Paper, p14.

A third example is the comparison of profitability of regulated and unregulated businesses. As noted below there will be some issues that affect the comparability of profit measures, but to the extent that there are systematic and sustained differences in profitability it may raise questions about the regulatory regime and allowed ROR. Sustained variations in profitability (after taking into account the factors discussed above), may suggest that the allowed ROE is either too high or too low. This should prompt the regulator to examine the underlying causes in more detail and review the approach and parameter used in determining the allowed ROE.

3.4.1 Use of RAB Multiples

In its previous submission CCP 18 supported the use of RAB multiples and noted that RAB multiples provide the most direct information available on the relativity of allowed and expected returns on capital or equity, and are easily observed at the time of transactions. They are commonly used by other regulators and investment advisors in examining transactions. Market value/RAB is the application to the regulated utilities of Tobin's q ratio, which is widely recognised in theory and investment practice. In particular, it has long been used as an indicator of market power.

The weakness of the RAB multiple measures is that further analysis is required to make the best use of the information on the relativity of expected and actual return. As such, it cannot be used in a mechanical manner. Such criticisms can also be applied to other measures of profitability when used to compare profitability across sectors and between regulated and unregulated businesses. While Tobin's q ratio is commonly used to compare profitability or investment value across businesses, it is not proposed that AER use it for this purpose. The primary use would be as a benchmark for assessing the relativity of expected and allowed returns across and within the sector.

The use of RAB multiples is also being considered through the current review of the ROR Guidelines and was discussed at the Concurrent Evidence sessions held of that review in March-April 2018. The experts at the concurrent evidence session agreed that[12]:

1. the investors' required expected rate of return is an important factor in, if not the driver of, the determination of market values
2. market-to-RAB multiples ('RAB Multiples') contain information on investor expectations that is relevant to the regulator's consideration of the appropriate rate of return if the implied rate of return in the valuation can be uncovered
3. RAB multiples will also reflect various other factors such as: expect outperformance against efficiency targets and other performance incentives; potential growth in unregulated income; differences in the market value and book value of debt; differences between the tax allowed by the regulator and expected tax payments.

The point of differences are whether:

1. estimates of the other sources of value can be made so as to uncover a plausible range for the implied required return that can be compared with the regulator's allowed return; and/or
2. there is a range for RAB multiples such that if RAB multiples across a range of transactions are outside that range it is strong prima facie evidence that the allowed rate of return exceeds investors' required rate of return.

[12] CEPA, Rate of Return Guideline Review, Facilitation of Concurrent Evidence Joint Expert Report, April 2018, p7, p35-36.

In the Concurrent Evidence Session the experts sponsored by the networks and investors were of the view that this information content could not be 'uncovered'. In contrast Professor Johnstone argued that while the implied return cannot be estimated with precision it is reasonable to draw qualitative conclusions from very high values.

CCP 18 broadly supports Professor Johnstone's position, which is consistent with the previous submission of CCP16 and other CCP sub-panels. We note that the research paper by Dr Biggar has also provided cautious support for consideration of RAB multiples in concluding:

> "Careful analysis may be able to isolate and adjust for the effect of these factors, "peeling away estimates of other sources of value". The resulting RAB multiple can be a useful sanity check on the operation of the regulatory regime. In particular, a RAB multiple close to one suggests that the investors in the firm expect to be adequately compensated in the future (whether or not the firm is delivering value-for-money to its customers overall). However, a RAB multiple which is materially and persistently different from one should be the trigger for closer investigation, to explore the potential reasons and the quantify the other sources of value.
>
> Still, after peeling away estimates of other sources of value, the RAB multiple may remain materially different than one. A key question is whether or not a regulator can use information on RAB multiples in setting the cost of capital. Should information on the RAB multiple be used to adjust the regulatory-allowed cost of capital up or down?
>
> Doing so gives rise to a potential problem of circularity – the value of the firm would then depend on the regulator's actions, which would depend, in turn, on the value of the firm. However the analysis in this paper suggests that this does not prevent the existence of an equilibrium in which the regulatory-allowed cost of capital is consistent with the RAB multiple and vice versa. This analysis suggests that there is scope for the regulator to take into account RAB multiples (as one amongst a range of factors) when setting the regulatory-allowed cost of capital despite the circularity issue."

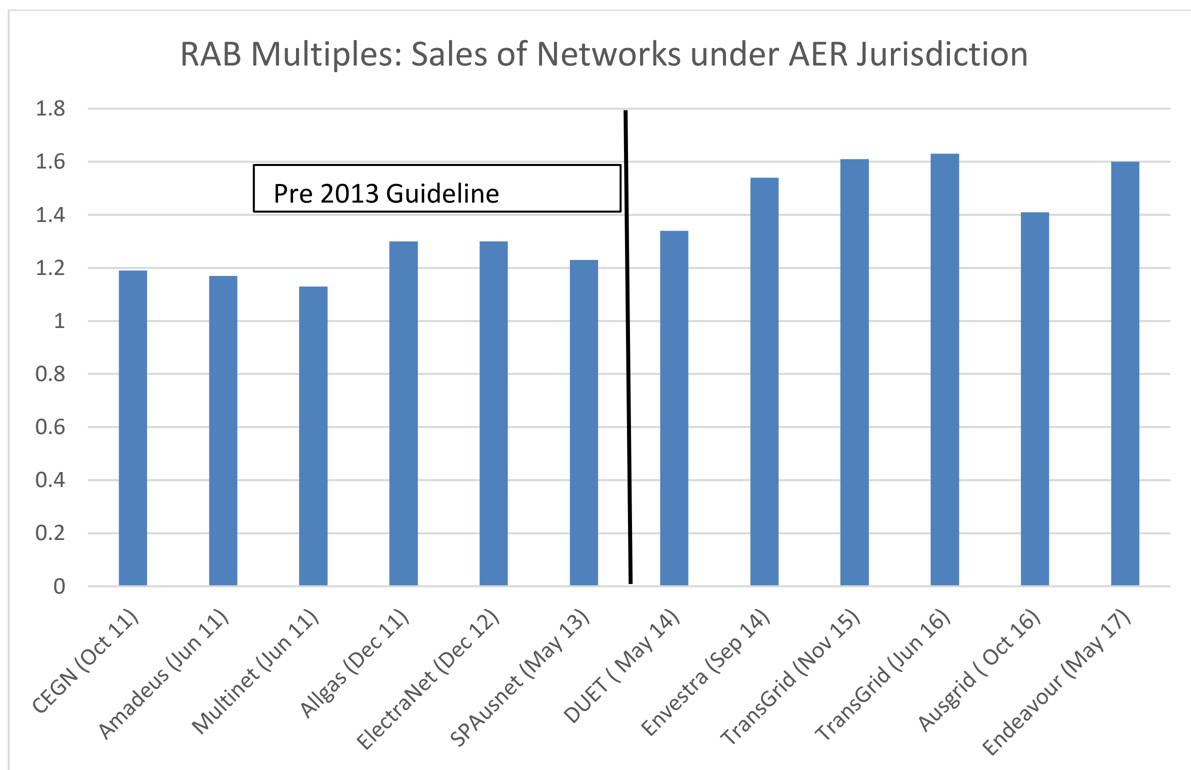
This conclusion is broadly in line with our earlier submission that emphasised that it cannot be automatically assumed that a premium above or below the RAB value indicates that the allowed rate of return is above or below the investors required rate of return. Careful analysis is required and assumptions must be made, but the key point remains – RAB multiples can provide useful information that can be used in a qualitative manner. Using RAB values, in concert with other measures, can, in a qualitative manner, help the regulator reach a reasoned, balanced judgement on the appropriateness of the ROR given the individual parameter estimates. On the other hand, to claim that the RAB multiple has no relevance to investor expectations of the regulated return on their investment suggests that the investing companies are naïve in the extreme.

However, we consider that the concerns in regard to circularity may be overstated. This would be a more significant problem if the decision on the ROR was specific to a utility and only had regard to the RAB multiple for that transaction. In practice the decision applies across all utilities and has regard to a set of transactions taken over time. Hence the feedback loops from transaction values to the ROR is greatly diluted.

Our previous submission set out in detail the precedents for the use of RAB multiples. In brief:

1. There are substantial regulatory precedents for the use of RAB multiples. A number of regulators (e.g. OfWat, CAA, Commerce Commission of NZ) have regard to RAB multiples as a qualitative check.
2. The use of RAB multiples draws upon accepted finance theory. Tobin's Q ratio which is the same concept applied to firms generally has been widely used in finance theory and practice in assessing firm value.
3. There is a substantial body of commercial precedent for the unbundling of value required to analyse RAB multiples. The CCP 18 submissions cited examples by CEPA and Credit Suisse but these are two of many. The analysis requires assumptions to be made and tested, but in essence is simply the reverse engineering of how bidders value the firm.

As Dr Biggar points out there are widely accepted benchmarks for RAB values. He suggests a range of 0.9-1.3 might be considered before citing a pre-GFC survey of analysts which indicate that a RAB multiple up to 1.2 was regarded as normal by 60% of analysts, but multiples beyond that raised questions. With that background the graph below is striking. It shows the RAB multiples for asset sales (whole or part) of energy networks under the supervision of the AER. Prior to the 2013 ROR guideline RAB multiples averaged around 1.2. Since then there has been an upward trend in the RAB multiples across 6 transactions over three years. While not proof it is consistent with the view that the 2013 Guidelines' parameters erred on the high side and that while the parameters (other than the risk free rate) have remained constant the gap to expected returns has increased.



Source: AER, Financial Performance Measures Discussion Paper, Feb 2018, Table 2, p 14.

3.4.2 Use of averages over time and NSPs

The AER's position paper notes that specific operational and environmental factors will result in variations from year-to-year and between NSPs. Hence the AER proposes to focus on trends over time rather than adjust the data for each NSP for these factors.

CCP 18 supports this approach as a practical approach that reduces the risk of putting too much weight on short term fluctuations. To the extent that the comparisons show sustained trends over time, the causes should be examined as set out above.

We consider that, for similar reasons, the AER should focus on results across groups of NSPs rather than individual NSPs. This would reduce the risk of placing too much weight on results for individual utilities. To the extent that there are systematic variations between different groupings of utilities it can provide a guide to the underlying causes.

4 Issues in specification and implementation of profitability measures

This section discusses various issues in the specification and implementation of the profitability measures.

4.1 Comparisons with unregulated businesses: statutory or regulatory measures

A key objective is to compare the profitability of the NSPs with other regulated businesses and unregulated businesses. Where other regulated businesses report on regulated returns on a real-on-real basis it is appropriate to compare profitability using regulatory financial reports. However, as McGrathNicol acknowledge, comparisons with other businesses are compromised by the difference between the determination of the RAB and depreciation under regulatory report and the statutory accounting framework.

Our previous submission stressed the need for comparability of the measures of profitability. In particular we noted that comparisons are distorted because part of the return to owners for the regulated businesses comes through the nominal capital gain through indexation of the RAB. ENA, albeit from a different perspective, stressed the need for comparability of the profitability measures.

McGrathNicol considered two options to provide profitability measures that are broadly comparable:

1. Adjust reported regulatory returns to be more consistent with the profits reported under the statutory accounting framework.
2. Require NSPs to provide financial statements consistent with the statutory accounting framework. These statements would be in addition to their regulatory reporting.

McGrathNicol concluded that the first approach "would be problematic due to lack of data, and complex. There would be a range of arguments as to what revenues, assets etc to adjust, which could leave the manipulated data open to criticism."[13] Hence, the second approach was proposed and accepted by the AER in its Position Paper.

[13] McGrathNicol, op cit, p2

The AER concluded that there is value in comparing the profitability of NSPs with firms operating in the broader economy[14] and that requiring the NSPs to provide financial statements on a statutory accounting basis provides the best basis for such comparisons.

CCP 18 supports the AER's proposed position. Indeed, in our view comparisons of profitability are essential, not just desirable, for the regulatory regimes legitimacy, credibility, and long term sustainability in the long term interests of consumers and service providers. Our previous submission set out our reasons in more detail. We agree that requiring the NSPs to provide financial statements on a statutory accounting basis is the most direct, transparent, and credible basis for comparing profitability. While it will entail some costs, CCP 18 considers that the costs will be very small compared to the potential benefits. Given that the combined RAB of the regulated energy networks is around $100 billion[15], the benefits of even small improvement in regulations and/or increases in its credibility would clearly outweigh any feasible estimate of the costs of preparing statutory accounts.

It is not necessary to reconcile profits on a statutory basis to profits reported in regulatory returns. The two measures serve different purposes and the objective of preparing the statutory accounts is to provide a measure of the funds available to shareholders/owners on a broadly comparable basis to similar measures for firms operating in the broader economy. Attempts to provide a reconciliation would face the difficulties identified by McGrathNicol in adjusting regulatory returns and would not add value. However, the AER may be able to present useful graphical presentations that provide a sense of the relationship between the two measures.

4.2 Asset valuation for statutory reporting

Two key issues in establishing statutory reporting will be:

1. the basis for the opening asset values
2. whether asset values are subsequently revalued and, if so, on what basis.

4.2.1 Initial asset valuation

The McGrathNicol states that the balance sheet provided by the NSP should be based on statutory accounting information[16] and "where the opening RAB did not approximate Depreciated Actual Cost ("DAC") at the time it was established, then RAB may not be comparable to the book values of the assets".[17]

This appears to leave the basis of the initial valuation of the assets open.

As McGrathNicol's comments suggest, DAC is the preferred basis for valuation of the opening asset basis for reporting in a statutory basis.

As noted in Box 1 below, although there is scope within Australian Accounting standards to revalue assets, asset valuation and financial reporting is predominantly based on historic cost accounting principles and this provides the best basis for comparison of profitability measures.

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[14] AER, op cit, p10.
[15] AER, State of the Energy Market, 2017, p96-100.
[16] McGrathNicol, Response to submissions on profitability measures, April 2018, p3
[17] McGrathNicol, op cit, p7.

BOX 1: ASSET VALUATION IN AUSTRALIA IN PRACTICE

Australian accounting standards permit companies to revalue non-current assets to fair market value. AASB 116 *Property, Plant and Equipment,* (paragraph 29) provides that:

> An entity shall choose either the cost model in paragraph 30 or the revaluation model in paragraph 31 as its accounting policy and shall apply that policy to an entire class of property, plant and equipment. (ASB 116, para 29)

Revaluations of non-current assets are to reflect market values and can be made on the basis of valuations made by directors or by independent valuers. Not all assets need to be revalued, but where a business chooses to revalue a class of assets, all assets in that class must be revalued. The challenge is that relatively few classes of assets are actively traded with market values readily obtainable. As a result, even where a business chooses to revalue some classes of assets, it is unlikely to revalue all non-current assets, in contrast to the indexation of the RABs for the regulated energy businesses.

Where an asset is revalued that increase is recognised 'below the line' in the income statement and included in an asset revaluation reserve unless it is reversing an earlier loss recognised through the income statement.

> If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss. (ASB 116, para 39)

A study of ASX 300 businesses found that only a small number of businesses revalued some of their assets to market values. The study examined the accounts for the businesses for the 5 years from 2003 to 2007. After excluding financial businesses and some observations where data was not available, there were 951 firm-year observations in the sample. Of these, there were 131 firm-year observations where at least some assets were revalued. The most common class of assets in which there was revaluation was Property, Plant and Equipment.

Table 2. This table describes asset revaluation across industries based on the two-digit GICS code. The assets that firm revalues include PPE, intangible assets and investment properties.

		Revaluation of assets				
2-digit GICS	Industry	N	PPE(1)	Intangible Assets(2)	Investment Property(3)	All Assets(4)
10	Energy	91	0	0	0	0
15	Materials	230	33	3	9	38
20	Industrials	201	18	3	12	27
25	Consumer Discretionary	163	22	5	10	24
30	Consumer Staples	82	26	0	5	27
35	Health Care	80	11	1	0	11
45	Information Technology	39	4	0	0	4
50	Telecommunication Services	41	0	0	0	0
55	Utilities	24	0	0	0	0
Total		951	114	12	31	131

Source: Hu, Fang, Percy, Majella, & Yao, Daifei (2015) *Asset revaluations and earnings management: Evidence from Australian companies*. Corporate Ownership and Control, 13(1), pp. 930-939. Downloaded from: https://eprints.qut.edu.au/91943/

It should also be noted that as a result of the Vertigan reforms of unregulated pipelines, there is a new information and disclosure framework to assist shippers in their negotiations with pipeline operators is to be published by 1 January 2018 with information disclosure from October 2018 under transitional arrangements and more detailed information from April 2019. This includes a lot of information on individual pipeline costs and profitability[18]. Importantly, the starting position is the "recovered cost" approach is defined as:

> "…the value of any assets used in the provision of the pipeline service is to be calculated as: (i) the cost of construction of the pipeline and pipeline assets incurred before commissioning of the pipeline (including the cost of acquiring easements and other interests in land necessary for the establishment and operation of the pipeline); plus: (ii) the amount of capital expenditure since the commissioning of the pipeline; less: (iii) the return of capital recovered since the commissioning of the pipeline; and (iv) the value of pipeline assets disposed of since the commissioning of the pipeline."

While the pipeline operators will still be able to argue for DORC, the starting point is historic costs. Hence, preparing accounts on a statutory basis that does not allow indexation of the RAB will enable comparison of the profitability of regulated and unregulated gas pipelines. We note that the AEMC is currently undertaking a review of "scheme" (i.e. lightly regulated and regulated) pipelines. Its February 2018 Draft Report proposed a range of reform including increased information disclosure around costs and tariffs. This may lead to different measures of profitability from the ones discussed in the AER Issue Paper so, in that case, there is a need to ensure comparability between different measures.

For NSPs subject to the full regulatory regime, the opening value of the assets on entry to the regulatory regime were revalued, mostly to an estimate of Depreciated Optimised Replacement Cost (DORC). In some cases, these values were subject to pragmatic adjustments – for example the values of the metropolitan DNSPs in Victoria were written up from DORC vales and the values of the rural DNSPs were written down from DORC values to be more consistent with the State-wide uniform price at the time. Importantly, estimates of the DAC values at the time may not be available. Furthermore, the date at which assets were initially revalued and the DNSP was first regulated under the national rules varies between utilities and jurisdictions.

Hence, the only practical way forward may be to accept the opening RAB at the time of entry to the national regulatory regime. This allows for the capitalisation of the initial benefits of asset revaluations but:

1. the impact of that initial revaluation on the statutory reporting will have diminished over time as those initial assets decline as a proportion of the total assets of the NSP
2. profitability measures (expressed as a percentage return) from that starting point will still be broadly comparable with those other businesses if they are calculated on a statutory basis without further indexation.

[18] . See http://gmrg.coagenergycouncil.gov.au/publications/draft-financial-reporting-guidelines-non-scheme-pipelines-0

4.2.2 Asset revaluation on acquisition

In line with practice in the rest of the economy, assets would not normally be revalued under the statutory reporting. However, at the public forum in May the issue was raised as to whether the assets of a regulated NSPP should be revalued on acquisition by another entity.

This issue arises where a business purchases a controlling interest in an NSP. Australian Accounting Standards (AASB 3) provides that in this case the assets acquired shall be measured at the fair value on acquisition date. The differences between the purchase consideration and the assets acquired, liabilities assumed, taking into account any non – controlling interest in the acquired entity (i.e. partial or full method) is recognised as goodwill.

There is a presumption in reporting under the statutory approach that the reports will comply with the accounting standards but it is not mandatory. In this case we consider that there are two options that the AER should consider:

1. Revaluation of assets on acquisition in accordance with AASB 3 with the capital gain being recorded as income and included in the measures of return on assets and return on equity
2. Not revaluing the assets.

No measure of profitability and comparison of measures is perfect. Different measures and comparisons will contain information and provide insights - the issue is how to make best use of this information and to recognise the shortcomings in the use of the information ***given the objectives of the measures***. In this case the question is which basis of measurement – historic cost or revaluation to acquisition values – best matches the basis of asset valuation in other businesses in the broader economy.

The primary advantage of not revaluing assets is that it enhances the comparability of the profitability measures because it is more consistent with the way other businesses value assets and avoids the volatility in yearly measures of profitability due to the inclusion of one-off capital gains under the alternative approach of revaluing assets on acquisition. As noted above there are provisions for revaluation of some assets to market values (including on acquisition) but there are also provisions for impairment of assets. In practice most assets in firms outside the regulated utility sector are recorded at historic cost less depreciation. (See Box 1 above which shows that in only 14% of the observations had companies revalued their assets). Given most businesses report on an historic cost accounting basis, that is the best basis for comparisons and the statutory accounts for the regulated businesses should reflect this.

The disadvantage of not revaluing assets on acquisition is that it is inconsistent with accounting standards.

The advantages and disadvantages of revaluing assets on acquisition are the converse of those of not revaluing. Its advantage is that it is consistent with accounting standards. Its disadvantage is that it makes comparisons of profitability with businesses in the broader economy more complex and difficult. A further key concern of consumer stakeholders is that it may introduce a circularity where higher business valuations due to the allowed ROR exceeding investors required ROR is capitalised and built into future returns.

Revaluation of assets would reduce the value of comparisons of profitability measures and/or make comparisons more difficult and complex. Comparisons would have to either:

1. focus on cumulative returns from the starting point (rather percentage returns in each year)
2. amortise the capital gain on acquisition over a fixed period.

After the assets are revalued on acquisition the annual profits in $ terms may remain the same but the percentage return on assets and equity will fall as the value of assets and equity will be higher. This would distort comparisons with other businesses which predominantly report on a historic cost basis.

In the year in which the acquisition occurs the capital gain could be include as income. This would result in apparently large profits in that year. Given that the transactions are large and relatively infrequent this would lead to substantial volatility in returns from year-to-year. However, the cumulative returns from the starting point could be compared with cumulative returns for businesses in the broader economy over the same period. However, it could be argued that the capital gain on acquisition is capitalising expected future excess returns. In this case amortisation of the capital gain over future years may be considered more appropriate and reduce the bias in comparison of profitability in percentage terms post revaluation.

The analysis above is not definitive but it serves to highlight the complexities that may follow from revaluations of the assets where, as the QUT study indicates, most comparator businesses have not revalued.

Furthermore, there is a concern that revaluation may and create a circularity. As noted above, if the allowed ROR persistently exceeds the investor's required ROR this will be reflected in the acquisition values. Use of acquisition values would capitalise the excess return and lower the observed percentage rate of return. If the regulator, looking at these ‘raw numbers’ only concludes profitability is comparable to normal levels, it may conclude that the approach to determining the ROR appears reasonable even though it in fact generates excess returns.

In summary, this is a practical issue with potentially significant consequences. No measure/comparison is perfect, but we consider that statutory measures based on historic costs of assets provide a better basis for comparisons of profitability than measures based on acquisition values. If the AER allows assets to be revalued on acquisition for statutory reporting it should also require NSPs to provide information sufficient to enable the profitability measures to also be calculated excluding the impact of the asset revaluation.

4.3 Adjustments for unregulated activities

Submissions to the discussion paper raised the question of whether profitability measures should exclude revenues and costs of unregulated activities. In response McGrathNicol proposed looking at profitability measures with and without the revenues and costs of unregulated activities. Comparisons with the allowed WACC should remove the revenues and costs of unregulated activities, but statutory profitability measures used to compare profitability with other businesses should include the revenues and costs of unregulated activities.

CCP 18 considers that McGrathNicol are correct in principle in drawing a distinction between comparisons with the allowed WACC and comparisons with the profitability of other businesses and

proposing to include revenues and costs of unregulated activities in the former and exclude them from the latter.

It should noted that for most NSPs a large proportion of revenue and earnings are generated by the regulated businesses. McGrathNicol found that 74% of revenues and 77% of EBIT were generated by the regulated activities.[19] We expect that in using profitability measures the AER will use aggregated weighted averages. AER could use regulated revenue in weighting the profitability measures for the different NSPs. This will reduce the weight given to those businesses with larger unregulated activities while avoiding the cost and complexity of preparing separate statutory accounts for regulated and unregulated activities.

4.4 Adjustments for incentive schemes

Submissions to the discussion paper raised the question of whether profitability measures should include or exclude revenues from incentives schemes. In response McGrathNicol proposed looking at profitability measures with and without revenues from the incentive schemes. Comparisons with the allowed WACC should remove the incentive payments, but statutory profitability measures used to compare profitability with other businesses should include the revenues from incentive schemes. AER noted that revenue from incentive schemes was a small percentage of total revenue. Given this, the AER did not consider it necessary to adjust revenues for the impact of incentive schemes, but proposed to identify any cases where incentive schemes have a significant impact on outcomes.

CCP 18 considers that McGrathNicol are correct in principle in drawing a distinction between comparisons with the allowed WACC and comparisons with the profitability of other businesses and proposing to include revenue from incentive schemes in the former. In regard to comparisons of actual and allowed returns we would characterise the adjustments for revenues from incentive schemes as the decomposition rather than exclusion. That is the difference in returns would be decomposed into their various sources, including the impact of incentive schemes. We also acknowledge that there is a practical dimension: if the incentives are on average small the adjustment or detailed decomposition may not be necessary. However, we would note that because profit is the residual between revenues and expenses a small impact on revenues may still have a significant impact on measured profitability. AER should provide data quantifying the impact of the incentive schemes on both revenues and profitability measures to assist stakeholders in assessing its proposed approach.

In considering the appropriate treatment of incentive payments it is important to be clear on:

1. the purpose of comparisons of profitability measures
2. the level at which comparisons will be made
3. the impacts on incentives.

The purpose of comparing profitability between NSPs and other regulated and unregulated businesses is to assess whether:

1. the returns available to shareholders/owners ***under the regulatory regime*** are systematically higher or lower than those in other comparable businesses

[19] McGrathNicol, op cit, p8.

2. the allowed returns exceed the investors required returns.

The first question looks at the impact of the regime as a whole, not just whether the allowed ROR is too high or too low. The revenues from incentive payments are part of the regulatory regime and ***to the extent that payments from incentive schemes are significant and systematically positive*** these revenues are relevant to the assessment of the regulatory regime. As noted above, if profitability measures show a significant difference further analysis of the sources is required, but the first comparisons should be at the aggregate level of profitability.

The second question compares the allowed returns with investor expectations in setting the ROR. Persistent positive revenues from incentive schemes are a positive non-systematic risk that should be reflected in the modelling of cash flows rather than the ROR. In this case, the AER also needs to consider if the revenues from incentive payments may be a significant factor in the observed RAB multiples and if so undertake sensitivity analysis to quantify the feasible range for the impact on the RAB multiples.

In using profitability measures for these purposes comparisons will be undertaken at an aggregate level over several years rather than for individual NSPs or for individual years. The objective is to identify patterns across multiple utilities and years. This reduces the extent to which the results are unduly affected by any one NSP or period. Incentive revenues will only affect the results to the extent that they are persistent, rather than transitory, and are common across NSPs.

Inclusion of revenues from incentive schemes will not affect the incentives for utilities to pursue improved efficiency. The incentives for efficiency improvements come from the separation of actual and allowed costs for each NSP for a defined period[20]. This is not affected by the inclusion of revenues from incentive schemes in the profitability measures. Estimates of future efficient costs would continue to be based on the AER's current base-step-trend approach, with the separation of actual and allowed cost defined by the regulatory period and the operation of the EBSS and CESS. Assessment and decomposition of profitability measures may feed into the implementation of the base-step-trend approach and design of the EBSS and CESS, but this will be applied across all utilities and be based on an aggregate analysis of trends in profitability measures. Any feedback from the profitability of an individual NSP in a specific period to the future revenues for that utility will be insignificant and will not affect incentives measurably.

4.5 Cost Allocation in calculating ROE

Calculation of net profit after tax (NPAT) on a regulatory basis will require interest and tax costs to be allocated between the regulated and unregulated businesses. As the AER notes, financing and tax strategies are managed at the group level for consolidated companies. McGrathNicol accepted that there is a range of possible allocation rules that could be used, but argued that "either allocations could be reasonably be made once guidance is put in place, or reasonable assumptions could be made to support the allocation of interest, tax, liabilities and equity".[21] It proposed that debt costs

[20] Common mis-perceptions of incentive regulation are that the size of the 'X – factor' affects the strength of the efficiency incentives or that NSPs should always expect that payments under the efficiency incentives will be positive.

[21] McGrathNicol, op cit, p10.

could reasonably be allocated on the basis of overall group financial structure and a relevant driver and tax could be allocated on the basis of the groups effective tax rate and revenue shares.[22]

CCP 18 endorses McGrathNicol's conclusions and recommends that the AER should specify the allocation rules to be used in order to strengthen the comparability of the profitability measures and reduce costs. The rules suggested by McGrathNicol provide a sound basis for the development of more detailed allocation rules.

4.6 Annual Reporting

The AER proposes to include in its annual performance reporting a public report and comparison of profitability measures. The reports will:

1. report profitability measures and relevant comparisons.
2. include commentary on the outcomes, factors driving the outcomes and caveats that should be considered in assessing the results

The NEL and NGL require the AER to provide the NSPs the opportunity to review and comment on the draft reports and the NSPs comments are published on the AER website. NSPS will be asked to review the data, calculated measures and the commentary on the outcomes.

It is critical that, as the AER proposes, the reports provide an analysis that looks beyond the headline numbers to the possible reasons for trends and variations. The report may note exceptions and results for individual NSPs, but the focus should be on the medium to long term trends and averages across DNSPs.

CCP 18 supports the requirement to provide a draft to NSPs for their review and comment but we recommend that AER also extend this to include other stakeholders or their representatives. This is is consistent with good practice, transparent regulation and will help strengthen the credibility and legitimacy of the regulatory process. Other stakeholders may not have the intimate knowledge of the numbers that the NSPs, but they can bring to the report a perspective and knowledge from outside the sector that can add value to the report. It is also practical, given the AER's focus on consumer engagement is providing it with more effective means of engaging with consumers and other civil society groups.

Finally, there should be a presumption that financial performance data on regulated NSPs should be in the public domain and any claims for confidentiality must be closely scrutinised.

[22] McGrathNicol, op cit, p11