

Submission to the Australian Energy Regulator (AER)

Consumer Challenge Panel

Submission to the AER on PWC “Advice on the allocation of interest and tax expense” for the calculation of return on equity (regulatory) profitability measure

Sub-Panel 18

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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.

Previous work of the AER in its Profitability Measures Review has led to a draft position of using six profitability measures. Four are based on regulatory accounting information and two are based on statutory accounting information. Earlier submissions by CCP18 have strongly supported the work of the AER in developing this range of profitability measures to better inform stakeholders.

This increase in transparency contributes to consumer confidence in the network regulatory framework achieving the National Electricity and Gas Objectives. Transparency is part of the social contract that comes with being a regulated monopoly and addresses the current information asymmetry between the network on the one hand and the AER and consumers on the other. These profitability measures can be used to give consumers an insight into whether the regulatory regime is providing the opportunity for networks to earn a commercial rate of return consistent with the risks they bear and consistent with the allowable WACC.

We agree with the AER that using individual measures can have limitations. However, using a wide range of measures can highlight different aspects of profitability to collectively indicate a trend, provide useful policy insights and be an input to future decision making.

As part of the AER's consideration of the details around how the network profitability measures will be calculated, CCP18 is participating in a number of workshops with the AER, network representatives and consumer representatives. We welcome the cooperative approach being taken by all parties as we seek to develop the detailed implementation methodologies for the agreed measures. This needs to ensure the chosen measures are understandable by stakeholders, their calculation methodology is robust and the data is a useful indicator of performance.

This submission considers two matters to be considered in these workshops – the allocation of interest and tax expenses for the calculation of return on equity (regulatory) profitability measure. To assist consideration of the complex issues involved, the AER has commissioned an expert report from PWC entitled "Advice on the allocation of interest and tax expense" dated 28th June 2019. This submission comments on that paper's recommendations as well as providing comment on the AER's overall implementation of the final profitability measures.

At a general level we agree with the AER's view in its Discussion Paper:

"While we acknowledge that these allocations are complex in view of differing corporate structures, we are of the view that it can be done." (p.3)

and its view, quoted in the PWC paper, that:

“...the additional cost of performing the analysis (to allocate interest and tax expense) will be outweighed by the benefit to stakeholders of reporting the Return on Equity Regulatory Information” (p.5)

and support the PWC recommendations.

Specific Comments on PWC Recommendations

Key principles in allocating interest and tax expense in a regulated entity

We do not profess to be taxation experts and hence our comments are more general in nature on the PWC proposed approach. While the writing is very dense, we believe that approach is thorough and the principals are supportable.

We agree with the proposed application of the AER ring-fencing principles in separating out regulated from un-regulated business activities, costs and revenues.

Recommendation 1 – Tax allocation for entities which are taxed as a company

We see the PWC recommendation as a relatively straight forward approach to relatively straightforward calculation.

Recommendation 2 - Tax allocation for “flow through” entities

We recognise that this is a complex area of tax law that we are ill-equipped to comment on in any detail. The variety of structures being utilised (MIF, superannuation fund, sovereign wealth fund) where the tax is paid by the ultimate shareholders in the holding vehicles, not at the level of the holding vehicle itself as is the case with corporate structures, leads to a variety of final tax rates – from zero to 30%.

Given this complexity, we consider the proposed approach of using a self-assessed blended rate to be a reasonable approach. We would recommend that the AER should:

- retain the ability to question an entity’s proposed blended rate if it is considered materially different from what the AER expected,
- be able to make a decision to either accept or reject the proposed blended rate, and
- if the latter, have the power to substitute an alternative blended rate.

Recommendation 3 – Allocation of interest expense

We favour Allocation method 3 because of its greater accuracy. Given the importance of the resulting profitability numbers to informing regulatory debate, accuracy should reign over simplicity in selecting the “relevant driver”. Given that profitability measures could potentially have a significant role to play in future regulatory considerations eg any future binding WACC decision, this suggests that accuracy, even if it involves more analysis, will be worth the cost and effort.

In particular, given that most networks are a mixture of varying degrees of regulated and unregulated assets, Option 3 potentially gives greater transparency around the allocation of debt funding for non-regulatory vs regulatory activities. Given debt for the former generally attracts a higher interest rate, the higher the mix of “regulated” and “un-regulated” debt, the more actual profitability might be understated.

While we see the simplicity of Allocation methods 1 and 2, we are concerned about their potential distortionary effects:

- For Regulatory EBIT/Statutory EBIT – the varying levels of profitability that can occur in the unregulated parts of the business
- For RAB/statutory Noncurrent Assets – the impact of an indexed RAB and non-regulated assets may be subject to changing (up and down) valuations dependent on business conditions or M&A activity

We think that both methods would create difficulties in measuring trend profitability over time. PWC comments:

“Similar to Allocation Method 1, RAB / Statutory Non-Current Assets (excluding DTAs) is a relatively uncomplicated measure, and therefore achieves the goals of simplicity and ease of interpretation for users of the profitability measures.” (p.32)

We would suggest that simplicity does not necessarily mean “...ease of interpretation by consumers”, unless this term is defined in terms of consumers understanding of the method of calculation. A measure may be easy or simple to calculate but that is of little use to consumers in this context if it means a sacrifice in accuracy which might leave open the prospect of future debates between stakeholders on the relevance of particular profitability measures.

We think consumers would prefer accuracy of output over their ease of understanding of the methodology. If the output of a black box (to general consumers, but not to the AER) calculation is an accurate input into profitability measurement, then consumers do not need to know the calculations in the black box. They only want to know that they can use the black box output with confidence in their advocacy given the AER due diligence has ensured the black box is operating accurately as intended.

While PWC recommends that:

“...Network businesses should be required to report the method adopted for transparency.”
(p.34)

we would go a step further and recommend that:

- Networks be required to use Allocation method 3,
- The onus of proof should be on networks to justify why they do not wish to use this method, and
- The AER to decide if the justification required is reasonable.

Final comments

These comments apply generally to the implementation of the profitability measures and have been triggered by reading the proposal approach in the particular matters considered in the PWC report.

It is not clear in the PWC or AER papers what due diligence process will be used to ensure that the information provided will meet the required levels of accuracy. The recently published ACCC Gas Inquiry Interim Report 2017-2020 contained a review of compliance with the Part 23 information disclosure requirements for unregulated pipelines. It concluded that:

“...the ACCC is concerned that some pipeline operators do not appear to be taking the information disclosure obligations under Part 23 seriously and are continuing to exploit information asymmetries to the detriment of shippers.”¹

and went on to detail major failures by various pipeline owners in providing that information that led, for example, to significantly inflated asset values and weighted average prices that do not provide a good representation of the prices actually paid by shippers. In the case of one pipeline owner, the ACCC concluded that:

“... a number of the measures appear inconsistent with the Guideline and potentially the access information standard, which states that information should not be false or misleading in a material particular. The ACCC will therefore refer this matter to the AER.”²

Consumers need to be confident that the information provided to the AER on profitability measures does not suffer from similar shortcomings. We would support the AER requiring any submission of profitability data to comply with the same reporting standards as currently apply to network provision of RIN data³ and for regular auditing of the information that is provided as the ACCC has undertaken with the Part 23 data.

CCP 18

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¹ ACCC Gas Inquiry 2017-20 Interim Report July 2019 p.128 <https://www.accc.gov.au/publications/serial-publications/gas-inquiry-2017-2020/gas-inquiry-july-2019-interim-report>

² Ibid p.150

³ See <https://www.aer.gov.au/system/files/AER%20final%20category%20analysis%20RIN%20-%20distribution%20network%20service%20providers.docx>