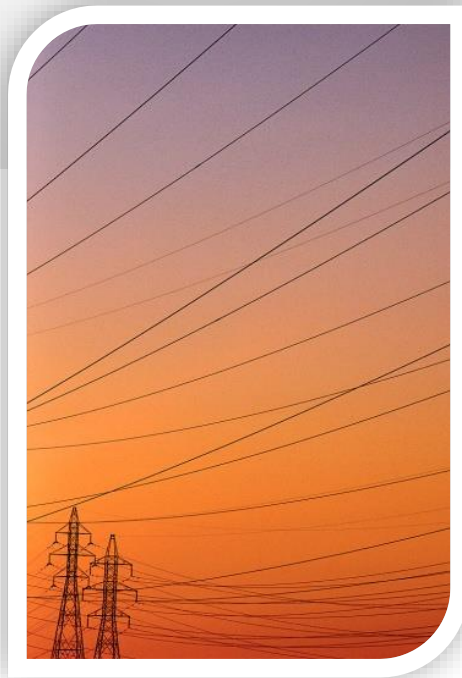


Public Forum on Profitability Measures 16 May 2018



Eric Groom

Outline

- Summary: Initial Response
- Objectives and use of profitability measures
- Proposed profitability measures
- Adjustments required
 - Regulatory and Statutory Accounts
 - Incentive schemes
- Role of RAB multiples
- Reporting

Initial Response

Position Paper Proposal	Response
Purpose: Transparency; Assess performance of regulation	Supported: assessment must → decisions (eg ROR)
Multiple measures to be used	Supported – different measures; different insights
Basis of measures: Statutory and regulatory	Supported – improves comparability, understanding of variations
Proposed measures: <ol style="list-style-type: none"> 1) Return on Assets (statutory and regulatory) 2) Return on Equity (statutory and regulatory) 3) Earnings per customer/connection 4) RAB multiples 	Supported subject: <ol style="list-style-type: none"> 1) to clarification of initial RAB in statutory accounts and sensitivity testing of allocations 2) requirement to analyse factors behind RAB multiples 3) use of RAB multiples as a directional indicator for ROR
Data collection: <ol style="list-style-type: none"> 1) New data requirements for statutory accounts (with allocation rules) 2) Statutory accounts to be audited 	Supported <ol style="list-style-type: none"> 1) Data requirements are reasonable and will add value 2) Rules on allocations should be mandatory, ensure comparability
Reporting: <ol style="list-style-type: none"> 1) Annual performance report to be published 2) NSPs can provide comments on draft report 	Supported with extensions <ol style="list-style-type: none"> 1) Annual report must analyse and interpret results 2) Other stakeholders to comment on draft

Consumer
Challenge
Panel

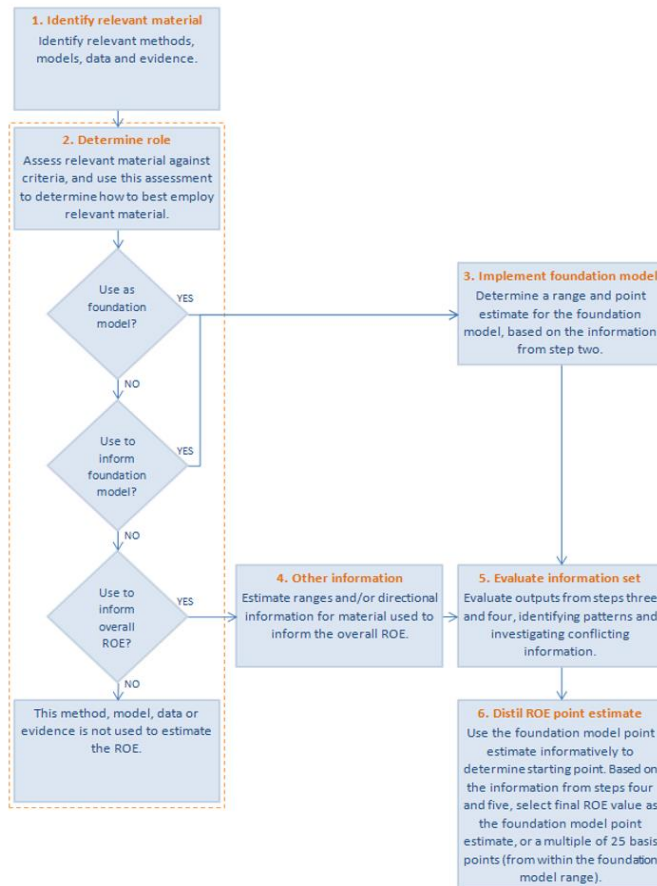
Objectives and use

- Objectives: 1) transparency; 2) review effectiveness
 - Missing but implied element: 3) improve decisions
- Use of measures:

Proposed Comparison	Comment
Expected (allowed?) returns compared to actual returns	Agreed (with clarification): Extent and basis for differences informs assessment of regulatory framework
Returns between providers in the same sector	Agreed: As above - informs assessment of regulatory framework
Returns between service providers another regulated/unregulated industries	Agreed: Can inform ROR and assessment of regulatory framework.
	ADD: Comparison of expected and allowed returns. Directly relevant to the ROR.

Incremental change

Figure 1 Proposed approach to estimating the return on equity



- Using profit measures is an incremental change only.
- Measures meet information criteria
- ROR approach includes cross-checks

Proposed Performance Measures

Issue	Measures	Comparisons and issues
Systematic variations between actual and allowed returns? Why?	ROA (Regulatory) ROE (Regulatory)	<ul style="list-style-type: none"> • 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)	<ul style="list-style-type: none"> • As above. Can highlight extent to which issues are systemic or provider specific
Are actual returns comparable to other regulated and unregulated industries (given risk level)? Why?	ROA (Statutory) ROE (Statutory) ROA (Regulatory) ROE (Regulatory)	<ul style="list-style-type: none"> • Comparisons with other regulated businesses can highlight impact of differences in reg regimes • Comparisons with other business (statutory basis) provides a guide to reasonableness of outcomes. • Will require careful analysis – but essential for credibility of outcomes
Are allowed returns in line with expected returns? Why?	RAB Multiples	<ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> • Comparisons over time only • Shows trends in profits and impacts on users

Consumer
Challenge
Panel

RAB and statutory valuations

- Proposal for reporting on statutory and regulatory basis supported
 - Essential for comparisons; benefits outweighs costs
- Opening asset values may still be an issue
 - Asset values at commencement of regulation are revalued, not historic costs
 - Data on historic costs may not be available
 - But
 - impact of asset values at commencement has diminished
 - affects absolute quantum of returns rather % ROR

RAB Multiples

- Inclusion of RAB multiples supported
 - Can inform ROR decision in a directional sense
- RAB multiples can be used by:
 1. Defining a normal range. RAB multiples outside the range indicate a potential problem.
 2. Analyse RAB multiples to estimate and implied ROR
- AER proposes (1), not (2).
 - Both should be used
 - Precedents for (2) - 'reverse engineers' bids.

Reporting

- Proposal for annual report on profitability supported
- Report should provide analysis as well as the numbers
 - To help understanding of comparisons and differences
- Draft should be shared with NSPs **and other stakeholders** to:
 - Review data
 - Comment in analysis, interpretation and conclusions
- Confidentiality claims?

Summary

- Strongly support the proposals
- Practical but broad in scope
- Should enhance credibility and legitimacy of regulation
 - In the interests of all stakeholders
- Expect it to be a process of continuous improvement
 - Key role is for AER to assess its own decision making
 - Important that AER reports back to consumers annually on its views on how it is performing & if/where the gaps.