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8 December 2017

Ms Kaye Johnston
Director, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601
Email: AERenquiry@aer.gov.au

Dear Ms Johnston

Submission on profitability measures for regulated gas and electricity network businesses

Essential Energy welcomes the opportunity to respond to the Australian Energy Regulator's (AER) discussion paper on profitability measures for regulated gas and electricity network businesses (the *discussion paper*). We fully support the Energy Networks Australia submission in relation to this discussion paper, but provide our own submission to provide further feedback on the proposed profitability measures and process.

The inclusion of simple, comparable and transparent profitability reporting measures by the AER could be a useful tool for stakeholders and customers. Throughout our extensive customer engagement programme, we have learned that our customers value affordability, transparency and simplicity. We believe reporting on profitability measures should be designed with these values in mind.

It is worth highlighting that ratio analysis alone does not provide a complete and meaningful measure of profitability. A number of factors may impact profitability, such as one-off or abnormal events, the timing of the regulatory determination against economic market conditions, operating environment factors relevant to the distributor or the success of the incentive mechanisms operating within the regulatory regime.

In terms of the proposed profitability measures, we agree with the AER's conclusion that return on assets (EBIT) would be the most appropriate profitability measure. Return on equity and economic profit are considered the next most suitable measures. Consistent with our feedback on benchmarking, we do not support a per customer measure as the results will be distorted by customer density and may provide misleading information to stakeholders.

Our preference is that the AER:

- > limit the data request to a generally retrospective basis, commencing from the start of our current regulatory control period; and
- > limit the number of profitability measures to two - return on assets (EBIT) using the Regulated Asset Base (RAB) as the denominator and return on equity.

Attachment 1 of this letter provides more specific feedback on the proposed measures and approach outlined in the discussion paper. Answers to the specific questions raised in the discussion paper can be found in Attachment 2 and our responses to the other proposed profitability measures are outlined in Attachment 3.

We thank you for taking the time to consider the points raised in this letter. Should you have any questions on this submission, please don't hesitate to contact Natalie Lindsay on 02 6589 8419.

Yours sincerely

A handwritten signature in black ink, appearing to read "Justin Hillier".

Justin Hillier
Chief Financial Officer

Attachment 1 – Feedback on the proposed profitability measures and approach

Proposed service coverage

We have assumed that the proposed data requirements would only be required for *standard control services*. This is on the basis that:

- > Other direct control services operate under a price cap mechanism, which includes no or limited profitability allowance
- > Alternative control services customer numbers and associated revenues are directly related to the number of services provided
- > Due to Power of Choice, metering will over time be transitioned to retailers
- > Ancillary network services and negotiated services do not have regulated asset bases (RABs) and have limited fixed assets, generally just a share of non-system assets like Buildings, Fleet and IT.

However, the discussion paper does not specifically discuss the services to which it is intended to apply. We would appreciate clarification as to service coverage in the draft decision.

Issues in providing data for the proposed measures

Balance sheet and cash flow elements

The discussion paper correctly points out that, as a regulated electricity business, Essential Energy already provides standard control services data for the majority of elements required for the four preferred measures. It is only if total assets are used as the denominator, instead of the RAB, in the return on assets (EBIT) measure and total equity for which data is required – but establishing this data in the first instance would be a difficult and time-consuming exercise, requiring significant assumptions to be made. This is due to the fact that, whilst our accounting system is designed to separately record revenue and split costs in accordance with our cost allocation methodology, we do not separately record assets and liabilities by business unit. As such, extracting balance sheet data for the standard control services business would take considerable effort in the first year of reporting, though we would expect the burden to be reduced in subsequent years.

Some items, such as debtors, would be fairly easy to separate, but other items, for example, shareholders equity or cash would be much harder to split between business units. This was certainly our experience in the first year of preparing 'Provisions' for standard control services for the Category Analysis regulatory information notice (RIN). Though, once the baseline was established, the roll-forward has been simpler.

This exercise would be further complicated by the differences in financial and regulatory reporting. For example, regulatory depreciation does not equal accounting depreciation, the RAB is indexed annually whilst the fixed asset register is not and the fixed asset register contains periodic revaluations that are not replicated in the RAB. This would cause disparity between the regulatory and financial reporting components and associated ratios.

Whilst Essential Energy provided balance sheet data to IPART in the past, the assumptions underpinning its preparation were extremely broad. As such, we do not consider the previously provided data to be a robust starting point for AER reporting purposes.

For the reasons outlined above, we would have identical issues in providing cash flow related data.

Back-casting data

We strongly suggest that the final rule only require the reporting of data for profitability measures from the commencement of the current regulatory control period and not require retrospective back-casting beyond this point. As described above, establishing a starting point for much of the data underlying the ratio components is a difficult task. The back-casting of data would require significant additional work and the overlay of further assumptions, especially given the added complication of business changes

over time, namely the separation of the Retail and Type 5 & 6 metering businesses. In addition, past returns are not an indicator of current profitability. As such, we believe the regulatory burden of providing long term historical data far outweighs any perceived benefit this data would afford.

Application of the data

Benchmarking is not a flawless tool

Due to the size of our network, our low customer numbers relative to the size of our costs and the accompanying RAB, Essential Energy may benchmark poorly on some of the proposed profitability measures. As such, we would like to see any proposed profitability reporting clearly state the limitations of benchmarking in assessing business performance.

Profitability ratios are a measure at a point in time and do not provide any explanation for a particular outcome. As such, we would like to see any benchmarking conclusions made in the proposed performance reports highlight where operating environment factors or any other influences have likely played a role in the result. Abnormal and one-off items across the network businesses will distort the results and make comparability across businesses and over years challenging.

How the data will be used

The discussion paper states that the AER will publish the profitability measures in performance reports and the measures will be used to compare actual returns against forecast returns as well as compare regulated businesses with each other and with other businesses. The discussion paper does not make clear how the AER intends to meaningfully interpret the data to highlight above or below average returns.

There needs to be a strong basis for what is deemed to be an expected, above average or below average return. It is important that customers and stakeholders are able to properly interpret the results without being misled by making incorrect assumptions around the drivers behind the results. Consideration also needs to be given to results over time, such as once-off above average returns in only a single year versus more sustained expected returns. Any external and one-off factors that impact the ratios also need to be carefully considered in reporting the results. The draft decision should state how the results will be used to inform AER decision making.

Limit regulatory burden

Given the AER is not obliged to consider profitability under the National Electricity Rules or the National Gas Rules and the significant effort that will be required to report the required data, particularly in the first instance, we would encourage the AER to make a draft decision that provides a path to improved value for customer affordability, transparency and simplicity. This can be achieved by limiting the number of profitability measures to just the return on assets (EBIT) using RAB as the denominator and the return on equity, bearing in mind that the return on equity afforded by the proposed ratio (net profit after tax/total equity) is not equivalent to the allowed return on equity provided in the regulatory determination process.

Naturally, investor expectations of return differ between markets. As such, it is particularly difficult to see how the operating profit per customer measure or the economic profit measure would allow the AER to meaningfully compare the results with other businesses in the broader economy. On this basis alone, these measures should not be pursued any further.

Attachment 2 – Answers to questions raised in the discussion paper

- 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?**

Noting our concerns with a per customer measure we agree that the selected profitability measures are the best measures to use based on the assessment criteria.

There would be a considerable amount of effort required to report the measures. We would prefer the number of profitability measures limited to just two – the return on assets (EBIT), using RAB as the denominator, and the return on equity.

- 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?**

Yes, we agree that the assessment criteria selected are appropriate. To be comparable, data must be consistent, regardless of the legal and financial structure of the regulated business.

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

Yes. If profitability measures are considered relevant to the AER's annual review, then the data will have to be provided by regulated entities. It is clear that there is currently insufficient data available to the AER to meet the desired objectives, around measuring and comparing profitability.

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

We do not suggest any alternative profitability measures.

- 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?**

Consistency of measures and data may be helpful and desirable, but may not be valid given the different types of ownership models and sectors of operation.

- 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?**

The benefit of any further suggested measures must be weighed against the potential regulatory burden. Where data disaggregation requires the application of significant assumptions, the integrity and robustness of the measures may be compromised.

Attachment 3 – Assessment of other proposed profitability measures

Financial performance measure	Formula	Comments
Return on Assets (net profit after tax)	Net profit after tax / RAB or total assets	Influenced by accounting and tax treatments Difficulty in providing total assets data for standard control services Can't be compared with businesses in the wider economy
Return on Assets (operating cash flow)	Operating cash flow / RAB or total assets	Influenced by financial and entity structure Difficulty in providing operating cash flow and total assets data for standard control services
Return on non-current assets	EBIT / non-current assets	Influenced by accounting and tax treatments Not as useful a measure of profitability Difficulty in providing non-current assets data for standard control services
Return on capital employed	EBIT / (total assets less current liabilities)	Influenced by accounting and tax treatments Difficulty in providing total assets and current liabilities data for standard control services
Return on invested capital	Net profit after tax / the book value of debt and equity less cash and cash equivalents	Influenced by accounting and tax treatments Difficulty in providing denominator inputs for standard control services Can't be compared with businesses in the wider economy
Net profit margin	Net profit after tax / total regulated revenue	Influenced by accounting and tax treatments Can't be compared with businesses in the wider economy
Operating profit margin	EBIT / total regulated revenue	Can't be compared with businesses in the wider economy
IRR	The IRR is the discount rate that results in a net present value of zero for an asset or project. The IRR is the actual economic return that is earned by the asset or project over its life.	Lacks consistency over time and is subject to particular entity circumstances Less accepted means of measuring profitability

Financial performance measure	Formula	Comments
Earnings per share and earnings yield	<p>Earnings per share is calculated as Net profit after tax / number of shares issued.</p> <p>Earnings yield is calculated as Earnings per share / share price. The earnings yield is the inverse of the PE ratio.</p>	<p>Difficulty in determining number of shares in government entity and the value of those shares</p> <p>Less useful measure given business is regulated</p> <p>Can't be compared with businesses in the wider economy</p>
RAB multiples	Enterprise Value / RAB	<p>Difficult to determine enterprise value</p> <p>Requires significant assumptions</p> <p>Less accepted measure of profitability</p> <p>Can't be compared with businesses in the wider economy</p>