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Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
Canberra ACT 2601

By email: rateofreturn@aer.gov.au

30 May 2018

Dear Warwick

Response to draft position paper on profitability measures for electricity and gas network businesses

Jemena welcomes the AER's invitation to provide feedback on the draft position paper on the profitability measures for electricity and gas network businesses (**draft position paper**).

We understand the concerns raised by consumer groups and other stakeholders about the profitability of network service providers (**NSPs**) and would like to assist the AER in developing these measures to provide an additional source of information for stakeholders to build trust and improve transparency within the regulatory regime. We also publish financial reports for Jemena Electricity Networks (**JEN**) and Jemena Gas Networks (**JGN**) that are publicly available.[1]

Reporting on profitability measures can be a useful tool for customer groups and stakeholders and can assist in understanding how NSPs are responding to the incentive regime. However, care is required in understanding different NSPs data that is necessary to develop these measures to avoid any misinterpretation. For example, NSPs may have different ownership and debt financing structures and this may require allocation of costs to individual businesses to make them comparable.

The AER, in its draft position paper, mentions that it will not use profitability measures in a mechanistic way to make adjustments to allowed revenue and will use the information only in contextual way. We appreciate the additional clarification afforded by the AER and encourage the regulator to e improve reporting and comparability of data among businesses.

Jemena supports the Energy Networks Australia (ENA) submission to the same consultation and reiterates the key messages:

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1 https://connectonline.asic.gov.au/RegistrySearch/faces/landing/SearchRegisters.jspx?_adf.ctrl-state=6k0u7t62o_4
https://connectonline.asic.gov.au/RegistrySearch/faces/landing/SearchRegisters.jspx?_adf.ctrl-state=17sj2f6qn1_4

- We support development and implementation of profitability measures
- We recognise consumers need for meaningful measures able to be used in a timely way and there are positive opportunities of getting this process right
- We see value in achieving clarity and alignment of expectations of stakeholders about how such information will be used before data publication begins
- We need to work together and work through mitigating the risks, complexity, and transparency associated with a 'half-way' house of adjusting statutory accounts towards regulatory accounts

The rest of this submission provides Jemena's considerations to assist the AER in collecting and analysing relevant data from businesses.

Ensure consistent adjustments to data to reduce risk of misinterpretation

Impact of ownership structure on NSP Financial Statements and ratios

The AER expects NSPs to provide income statement and balance sheet at NSP level (for both JEN and JGN). It also wants information on profitability ratios such as ROA and ROE. To measure these the AER will need to allow for different ownership structures. For example for some businesses such as Jemena, debt is raised at the group level and there is no debt allocated to the individual NSP.[2]

As a result no finance cost is calculated at the individual NSP level. Similarly, existing tax at NSP's level is calculated on earnings before interest. Therefore these financial statements would require series of adjustments/allocations to account for allocation of interest, tax, debt, equity, fair value adjustments, related depreciation and amortisation etc.

It is also important that consistent adjustments are made to numerator and denominator when determining ROA and ROE. For example the allocation of finance cost in numerator should be consistent with allocation of debt in the denominator.

EBIT per customer

We consider that any measure that is on a "per customer", such as EBIT per customer, measure is likely to be misinterpreted. This measure will differ materially between businesses due to difference in customer density, difference in business sizes, age of assets and different mix of customers (large industries, small industries and residential). We encourage AER to further engage with businesses to allow for normalisation.

An average per customer measure reflects profitability for both residential and business customers. We are concerned however that it has the potential to be misunderstood by, for example, residential customers as a reflection of average residential bill. It may also be misunderstood as a shareholder profit per customer.

A per customer earning measure does not capture high *shared network costs* to residential customers because of the differences between costs and volumes across the different customer classes.

[2] Jemena Electricity Networks (**JEN**) and Jemena Gas Networks (**JGN**)

RAB multiple

This is a forward looking measure and is relevant only for a period of time. We don't believe that this measure will provide much value to the consumer group who are trying to assess the profitability of the businesses based on historical data and is likely to cause confusion if not interpreted correctly.

Adjustments are done correctly between statutory and regulatory information

McGrath Nicol has suggested that there can be issues in reliably comparing the regulatory returns to statutory returns and mapping statutory accounts to regulatory accounts can be complex and cumbersome. Therefore they recommended to the AER that it collects and use both regulatory and statutory data and provide two sets of measures for ROA and ROE.

The ENA has noted concerns with adopting this approach which would have the effect of drawing any kind of consistent picture from the two sets of information impossible. Therefore, we strongly support the recommendation from the ENA that:

- If the accounting framework is to be sufficiently comprehensive to provide a solid basis for discussion about profitability, it also needs to reflect the joint understanding of all stakeholders about what that basis ought to be.

- The AER should embark upon a process, involving all stakeholders, to develop a robust and sustainable set of regulatory accounts for longer-term use and to this end, adopt a working group process is widely used to develop standards. This is the best way to ensure that all stakeholders play an active role in the development of a robust regulatory accounting framework for use by the AER.

To provide preliminary examples of the work ahead, we provide concrete examples of types of adjustments in the table below. broadly across regulatory and statutory statements –

Table 1 – Jemena's preliminary recommendations for further consultation

Financial Statement	Regulatory and Statutory Statements adjustments[3]	Statutory Statements adjustments
Profit and Loss	Revenue calculation to remove any payments made to incentive mechanisms such as STPIS, EBSS and CESS. These payments do not relate to the year in which they are received and are likely to distort the financials measures and sends the wrong signal to customer groups and market participants.	Depreciation and Amortisation should be adjusted for any fair value uplifts that are currently held outside the statutory accounts of the NSP (JEN and JGN level).

[3] Jemena doesn't suggest any changes to statutory statements at service provider level. All the required adjustments are suggested to be made at the JEN and JGN level and shown as reconciliation to statutory accounts

	Tax expenditure should be calculated at effective tax rate of 30% after allocation of notional finance costs on earning before tax to ensure consistency across NSPs.	
Balance Sheet	Notional Debt would need to be allocated (including working capital) to the balance sheet of the NSPs (JEN and JGN) where the debt is held at group level. Enterprise value (FCFF) will only be true to the extent there is market value of debt. NSPs that are unlisted would need more guidance on Enterprise value is estimated. Treatment of equity including any impairment allocated to retained earnings (equity) should be considered from normalisation and disclosure purposes. This includes impairment of intangibles/ fair value uplifts held at consolidated group accounts.	Fixed Assets allocation to include normalisations for push down of goodwill, fair value adjustments and any differential accounting treatments between NSPs (JEN and JGN) and group statutory accounts

Alignment on collected information and profitability measures

Further clarity is required on the calculation methodology for each of the profitability measure. For example, providing clarity on what value of RAB to be used for profitability measures (opening, closing or average), etc. Any calculation methodology should be clearly set out in the guidance to all service providers to ensure a consistent approach for calculating the measures.

We also recommend that with growing information requirement from the AER (along with other regulatory information notices) it is opportune time to consider an online data management system that can be accessed by all stakeholders and allows comparisons among various NSPs. Such a system will also allow for direct population of data in the online system.

If you wish to discuss this submission please contact Sandeep Kumar [redacted].

Yours sincerely

[redacted]

Usman Saadat
General Manager Regulation