MEU Inc

Major Energy Users Inc.

22 August 2019

Mr Warwick Anderson
General Manager
Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

By email to: AERinquiry@aer.gov.au

Dear Warwick

Profitability measures for electricity and gas network businesses
Discussion paper on allocations of interest and tax

The Major Energy Users Inc (MEU) thanks the AER for providing the opportunity to provide input into the discussion paper addressing allocations of interest and tax when calculating the return on equity (regulatory) profitability measure.

The AER has commissioned PwC to undertake analysis of the options available to determine how best the aspects of interest and tax could be accommodated in developing a return on net profit after tax (NPAT) – a key element in assessing the return on equity – on a regulatory accounting basis.

As a fundamental concern, the MEU considers that the networks will have an incentive to minimise the regulatory NPAT they declare in their profitability measures analysis as this would provide support for a view that AER regulatory allowances for return on equity might be too low. This means that any approach developed for the calculation of the profitability measures needs to reflect that the networks will be seeking to move as much cost as they can into the measure for regulatory NPAT. In relation to the approaches used to assess the tax and interest costs for the regulated entity, the networks have an incentive to maximise these "costs" in order to minimise the outturn NPAT value. The MEU considers that the AER (and PwC) must take this reality into consideration as they develop their approach for this measure.

The MEU points out that in assessing regulatory NPAT, it needs to be recognised the AER assesses its return on capital calculation based on the assumption of the network being a "pure play regulated energy network business operating within

Australia" so it is important that the approach developed by the AER reflects this definition, as it is on this basis that the AER sets the return on capital it allows the regulated businesses.

Equally, the MEU notes that most of the energy networks have a mix of regulated and unregulated income, and that these same firms have different approaches to allocating interest and tax liabilities as well as limiting tax payable.

The MEU supports the AER decision to seek expert input on how best to address these aspects to ensure the most appropriate outcome is achieved.

The AER posits five questions:

1. Do you agree with the key principles identified by PwC for the allocation of interest and tax expense to the regulated entity?

The MEU considers that PwC has approached their task in an appropriate manner. They have explained well why they have approached the task in the way they have and the reasons for the conclusions they have reached.

The MEU notes that PwC has attempted to ensure there is consistency between the work they did for the AER in its tax allowance review – the MEU agrees that consistency is essential across the different elements of the AER functions for regulatory resets. The MEU considers that as the primary purpose of the profitability measures is to allow comparisons between allowed and actual outcomes, it is essential that the structure of the development of the allowed values be as close as possible to the structure of the actual measure.

The MEU points out that the networks can and do raise revenue from use of the regulated assets that is considered to be non-regulated revenue. While there are tools that allow consumers to benefit from this non-regulated revenue, the large proportion of the benefit accrues to the networks. What is not clear in the PwC report is the extent to how this reality has been addressed in its analysis and recommendations.

There is some discussion in the PwC report about how the impact of the difference between the "actual" asset base (statutory asset base) and the "indexed" RAB is to be managed. While statutory accounting requires the amount from indexing the RAB to be sequestered in a separate account so it is not taken to profit[1].It has not been made clear by PwC how this issue is addressed in its analysis and recommendations for assessment of NPAT, tax liabilities and interest payments.

[1] In statutory accounts, any amount that occurs from revaluation of an asset is taken to be a profit

2. Do you agree with PwC's recommended approach for allocating tax expenses for corporate structures?

Subject to the comments above, the MEU considers the proposed PwC approach provides a pragmatic solution to the issue.

3. Do you agree with PwC's recommended approach for allocating tax expenses to flow through tax structures?

Subject to the comments above, the MEU considers the proposed PwC approach provides a pragmatic solution to the issue.

However, while accepting the premise of self assessment, the MEU considers that the network firm should be required to provide an explanation to the AER as to how it has carried out this self assessment and what the reasons are for its particular approach.

4. In light of the advantages and disadvantages that PwC sets out for its three interest allocation approaches, which of these allocations should be used, and why?

The MEU recognises the detriments of both methods 1 and 2 as highlighted by PwC in their abilities to skew the outcomes of the allocation for:

- the EBIT approach (where the profit from the non-regulated services is higher or lower than for the regulated services) and
- the asset base approach (from indexation of the RAB or any revaluation of non-regulated assets)

where the denominator (statutory EBIT or Statutory noncurrent assets) could be less than the numerator (regulatory EBIT or RAB) with the outturn being that the interest allocated to the regulated business would be greater than the total interest. Even if the outturn is unity or less, losses for the non-regulated services or where there is a small proportion of non-regulated assets in the total asset base will bias the outcome. The MEU agrees with PwC that these approaches, while simple and easy to implement could provide significantly skewed outcomes. On this basis, the MEU does not support either of these approaches being used.

The MEU considers method 3 is more equitable and likely to provide a more accurate outcome and therefore is supportive of its use.

However, despite support for this method 3, the MEU does have a concern in that interest charged is based on the entire portfolio of high and low risk assets, yet in apportioning the interest, the interest charged for regulated assets should be lower (eg based on the credit rating of BBB+ used by the AER) than the rate charged for the non-regulated assets which might provide a more risky service an have a lower credit rating (eg where the cost of debt is related to a credit rating of say B[2]). So by apportioning the interest based purely on an asset split between regulated and unregulated assets, the regulated assets will incur a higher share of the interest than they might if the interest was based purely on the fundamentals of the risk.

The MEU considers that as a part of the apportionment approach, the relative risk for each asset class also needs to be a consideration in the apportionment.

5. Are there any further allocation approaches we should consider for tax and/or interest expenses? If so, please identify why you consider these approach/es preferable to those identified in the advice.

Subject to the foregoing comments, the MEU considers that PwC has adequately provided approaches that should meet the needs for developing the profitability measure elements under consideration.

Should the AER require additional explanation as to the concerns expressed herein, please contact the undersigned.

Yours sincerely

[redacted]

David Headberry
Public Officer

[2] An obligation rated 'B' is more vulnerable to non-payment than obligations rated 'BB', but the obligor currently has the capacity to meet its financial commitments on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments on the obligation.