



Response to submissions on profitability measures

Australian Energy Regulator

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McGrathNicol

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Review of submissions

- Following the publishing in November 2017 of the AER's discussion paper on profitability measures, the AER sought submissions from stakeholders.
- Given McGrathNicol's previous engagement to conduct a Scoping Study into profitability measures, the AER engaged McGrathNicol to provide a response to issues raised in submissions on the AER's discussion paper.
- Two major issues raised in the submissions that the AER wanted McGrathNicol to respond to were:
 - Comparability of statutory and regulatory financial information; and
 - The ability of service providers to determine / allocate interest and tax, liabilities and equity.



Comparability of statutory and regulatory financial information

- AER objectives for the profitability measures is that the performance of the network service providers may be able to be compared to the returns of businesses in the broader economy.
- The ability to compare the returns on a RAB for a service provider to returns of non-regulated businesses is compromised due to the differences between regulatory and statutory financial information.
- We consider that to try and make adjustments to compare regulatory to statutory information would be problematic due to lack of data and complexity, and as any adjustments are likely to be open to criticism.
- A sensible approach would be to obtain both regulatory and statutory financial information from service providers.

Comparability of statutory and regulatory financial information

- We consider that the AER should require service providers to provide the following:
 - An income statement to the net profit after tax level, for the service provider based on statutory accounting information;
 - An income statement to the net profit after tax level based on regulatory accounting information presented at the service provider level and the core regulated service level;
 - An explanation of adjustments to get from the statutory income statement to the regulatory income statement;
 - A balance sheet for the service provider based on statutory accounting information; and
 - RAB balances.
- We suggest that the AER should not require service providers to provide a balance sheet based on regulatory accounting information as it would have limited value.



Ability to allocate interest and tax

- Difficulties that may be faced by a business in allocating interest and tax expenses, and liabilities and equity to a service provider where it is part of a larger group.
- There could also be further difficulty for a service provider to allocate to the core network service level.
- The position of some businesses appears to be that it is not possible to make reasonable assumptions that would enable a meaningful allocation of tax, interest, liabilities and equity.
- This may be due to the likely increased cost that would be borne by service providers in producing this information.
- The allocation of interest, tax, liabilities and equity will be easier for some service providers than others.
- It is not correct to suggest all service providers could not make these allocations given that a number already do (at least in respect of interest and tax) in their annual reporting RINs submitted to the AER.

Ability to allocate interest and tax

- A service provider may be able to make reasonable assumptions to support the allocation of interest, tax, liabilities and equity.
- AER may need to provide guidance on how allocations should be approached.
- For a service provider, reasonable assumptions might include:
 - that the overall group financial structure (percentage of debt to equity) applies to the regulated business;
 - that interest payable by the service provider is allocated based on a relevant driver;
 - that the tax payable by the service provider is based on the group's effective tax rate applied to the service providers' net profit before tax;
 - that in allocating from the service provider level to the core regulated service level, allocations are based on a driver such as percentage of revenue.
- Inclusion of commentary / explanation on allocation approach would assist in interpreting the results.
- Problems may be encountered in gaining assurance over the allocations of interest, tax, liabilities and equity. AER guidance on approach to allocations may assist this.

