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Mr Scott Haig
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Dear Scott

By Email

Response to submissions on profitability measures

Scope

In accordance with the order for services dated commencing 12 February 2018, McGrathNicol was engaged by the AER to assist it in its review of profitability measures to be applied to the energy network businesses.

McGrathNicol was requested to provide a response to issues raised in submissions on the AER's discussion paper. This letter sets out a number of issues raised in the submissions that the AER identified it would be helpful for McGrathNicol to respond to.

Definitions used in this letter

Service Provider – In the electricity sector, the service provider is the regulated network service provider (as defined under the National Electricity Law). For the gas sector, the service provider is the scheme pipeline service provider (as defined under the National Gas Law). Balance sheet and income statement information is to be reported for this legal entity.

Statutory accounting information – financial information that has been prepared in accordance with the Corporations Act, including relevant accounting standards. Statutory accounting information is to be prepared for the service provider.

Regulatory accounting information – financial information that has been prepared in accordance with regulatory rules. Regulatory accounting information is to be prepared for the service provider and the core regulated service of the service provider.

Core regulated services – in the context of electricity distributors, the core regulated services are Standard Control Services. For electricity transmission network service providers, core regulated services are Prescribed Transmission Services. For gas transmission and distribution service providers, core regulated services are Haulage Reference Services.

McGrathNicol commentary on issues

Concern / issue	McGrathNicol response
1. Comparison of measures Network businesses noted difficulties in comparing profitability of regulated networks with other businesses operating under a statutory accounting framework. In particular they noted differences around the treatment of asset values and depreciation. Network businesses proposed limiting comparisons to regulatory benchmarks given the difficulties in making comparisons with other industries. Although acknowledging some differences in approach between statutory information and regulatory information, consumer groups such as the MEU strongly supported a comparison of the regulated businesses against businesses operating in the broader economy. In the MEU's view, the key adjustments to regulatory accounts to make valid comparisons were the removal of indexation and the optimisation of the regulated asset base. "Any comparisons must be made on a like for like basis. In this regard, there are problems comparing regulatory accounts with statutory accounts because the two have been prepared using different rules, and thus differences between them could be reflective of nothing more than these different rules" (ENA p4-5). "...there is a need for carefully considered comparisons, based on firms facing a similar level of risk and operating circumstances, between businesses in the regulated energy sector and in the wider economy...there is merit in exploring this and consider that comparisons outside the regulated energy sector assist in avoiding problems of circularity, whereby outcomes are only ever compared with regulatory assumptions" (ENA p6). "Should the AER introduce new profitability reporting, its regulatory determinations should	<u>Comparison of regulatory returns to statutory returns</u> The ability to compare the returns on a RAB for a service provider to returns of non-regulated businesses is compromised to some extent. This is due to the difference between the RAB (which may be based on a valuation approach inconsistent with accounting standards and includes indexation) with total assets determined under a statutory accounting framework. We see issues in reliably comparing **regulatory** returns to **statutory** returns. <u>Should adjustments be made to data to make it more comparable?</u> It is possible to try and enhance comparability by manipulating data to make either regulatory data more consistent with statutory data, or vice versa. For example: ▪ Remove the impact of indexation and different asset valuation approaches from the RAB. ▪ Adjust total assets for non-core services assets to try and make them more consistent with a RAB, or add non-RAB assets (current assets, intangibles etc) to the asset base of the service providers to try and make the asset base more consistent with total assets of a non-regulated business. However, we consider that to do this would be problematic due to lack of data, and complex. There would also be a range of arguments as to what revenues, assets etc to adjust, which could leave the manipulated data open for criticism. <u>What data should be collected by the AER from the businesses</u> A sensible approach for the AER to adopt may be to implement a framework which requires the data required to calculate key metrics to be provided, so that a range of ratios can be calculated. Where a

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<tr><td>produce a benchmark measure of the same metrics, to ensure like for like comparisons are made with the reported data" (AusNet p3-4).
"To the extent the AER determines that profitability measures provide relevant information for stakeholders:
– the AER should consider publishing a benchmark measure of profitability to facilitate like-with-like comparisons; and
– to avoid issues of circularity, actual returns from other industries should preferably be used as a relevant cross check" (SAPN et al, p1).

"The greatest value in EBIT as a measure of profitability will be from comparisons with non-regulated businesses, and such comparisons will require adjustments if they are to be on a like-for-like basis (CCP, p16).

"Comparing the profitability of networks to a cohort of other capital intensive firms will better inform the AER as to the approaches it uses in the regulation of networks" (MEU, p1).

"It is important to ensure both time series and cross sectional analysis is used, with the latter comparisons made against various peer groups, i.e.
– comparison over time;
– comparisons with other regulated businesses (energy and other); and
– comparisons with other businesses (defined as broadly as possible)" (CCP, p8).

"Comparisons with other regulated businesses need not be limited to Australia" (CCP, p9).</td><td>service provider has difficulty in providing the data and is required to make assumptions, they should detail these assumptions.

We consider that the AER should require service providers to provide the following (consistent with our scoping study):
– An income statement to the net profit after tax level, for the service provider based on statutory accounting information;[1]
– 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;[2]
– An explanation of adjustments to get from the statutory income statement to the regulatory income statement, noting that this should relate to differences between the regulatory and accounting standards/approaches (such as the treatment of depreciation expense).
– A balance sheet for the service provider based on statutory accounting information. This would include RAB assets at accounting values, plus other assets such as current assets and intangibles, liabilities and equity.
– RAB balances.

We suggest that the AER should not require service providers to provide a balance sheet based on regulatory accounting information as it has limited value, specifically:
– It requires significant adjustments of asset values (e.g. the allocation of the difference between the RAB and the book value of assets to equity), which could lead to calculation of a misleading return on equity; and
– A return on regulatory equity can be calculated by applying a benchmark gearing to the RAB.</td></tr>
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[1] Noting that in practice the AER will require one income statement that includes columns for statutory and regulatory financial information, and an adjustments column which highlights the difference.

[2] Noting that in practice the AER will require one income statement that includes columns for statutory and regulatory financial information, and an adjustments column which highlights the difference.

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"However, in comparisons with non-regulated businesses, it may be necessary to adjust for the impact of the indexation of assets and a real rate of return for regulated businesses" (CCP, p17).	What comparisons could be undertaken? We note there is no perfect comparison. However, if the relevant data is collected, we consider that the best comparisons may be made between: > EBIT / RAB measure (based on regulatory accounting information) for a service provider to other service providers. > EBIT / RAB (based on regulatory accounting information) for a service provider to the pre-tax WACC for the relevant year. > EBIT / RAB (based on regulatory accounting information) for the service provider to overseas regulated energy businesses, where the RAB is valued on a reasonably consistent basis. > EBIT / RAB (based on regulatory accounting information) for the service provider to other regulated business outside of the energy sector, where the RAB is valued on a reasonably consistent basis. > EBIT / total assets (based on statutory accounting information) for a service provider to all other service providers and businesses in the broader economy with a similar level of risk and capital intensity. > Return on equity (NPAT) (based on statutory accounting information) for a service provider to all businesses in the sector and the broader economy). > Return on regulated equity ratio ("RORE") for a service provider to other service providers and to the return on equity allowed in a service provider's regulatory determination. Comparisons may be possible to overseas regulated energy businesses where the RAB is valued on a reasonably consistent basis, and the benchmark debt to equity ratio is similar to that in the Australian regime.
2. Suggested adjustments to data – unregulated activities	To compare return on assets (EBIT/RAB) with regulatory benchmarks (such as the relevant WACC), this measure should focus on the core regulated service for the service provider.

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"Must adjust earned revenues to segregate the impact of revenues on unregulated activities" (APA, p10). "The EBIT measure should be reported to exclude unregulated revenue, and after giving effect to the impact of the incentive mechanism relevant to the regime" (APA Group p11). Significant manipulation of data or adjustments would be required to translate regulatory financial information to any meaningful form of Australian Accounting Standard information" (APA Group, p7). "The use of regulatory accounts will better ensure consistency across all regulated frameworks" (SAPN et al, p3). "Due regard must be given to the impact of the existing regulatory arrangements on the measurement of profitability, including: – Profitability metrics should relate to the regulated business only" (ENA p3). Energex, Ergon and Essential consider that the EBIT/RAB measure should be based on standard control services only.	McN agree that in order to compare the **regulatory** EBIT/RAB measure to the pre-tax WACC, other regulated services and unregulated activities should be removed from revenue and opex. For example, total EBIT at the service provider level should not be used in calculating the regulatory EBIT / RAB measure, as this includes negotiated distribution services and unclassified services, where revenue is not determined based on the allowable return on the asset base. However, for comparison to other industries, there is merit in calculating a **statutory** EBIT / total assets measure, that will include all regulated and unregulated activities and assets of the service provider.
3. Suggested adjustments to data for ratios – incentive schemes "Must adjust revenues to segregate the impact of earnings related to performance against incentive mechanisms" (APA Group, p8). "in an incentive based regulatory regime, it is important for any profitability measure to be able to segregate the impact of a regulated business' responses to the incentives inherent in the regime to ensure that this is not interpreted as economic rent or excess profit" (APA Group p8). Incentive measures should include not just EBSS and STPIS, but the incentives inherent in the regime, including the regimes incentives to	We consider there is value in collecting information on the revenue earned (or penalties deducted) in respect of incentive schemes in each year. The total incentives / penalties would respectively be subtracted / added to EBIT and NPAT. McN believe that there is merit in calculating the profitability ratios both including and excluding the impact of incentive revenues. The point raised by the network businesses is that if comparison is to be made to the pre-tax WACC, then the impact of the incentive mechanisms should be removed. We agree with this for the purposes of the regulatory ROA, as the WACC (as a benchmark) does not take into account these incentives.

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reduce costs and, in a price cap regime, to increase utilisation". (APA Group p11). "need to deconstruct the earned revenues to report the effect of incentive mechanisms (the EBSS, opex and volume outperformance etc)" (APA Group p8). "Due regard must be given to the impact of the existing regulatory arrangements on the measurement of profitability, including the incentive regulation framework" (ENA p3). "The key consideration is the intended use of the profitability measures in the incentive framework" (SAPN et al, p4). "It is accepted that the overall structure of the regulatory framework is one of 'incentive regulation'. Networks rightly have the opportunity to earn true profit – returns above the cost of capital – but that opportunity should only be available where they genuinely 'outperform' against cost and service delivery benchmarks"… (ECA, p2).	For the purposes of calculating ratios based on the statutory information, there is merit in including incentives so that the total return generated by the service provider can be compared to other businesses.
4. Suggested adjustments to data – timing of decisions, revenue smoothing "The timing of regulatory decisions, insofar as different WACC parameters are applied across businesses, may also affect earnings comparisons" (AusNet p3). "Due regard must be given to the impact of the existing regulatory arrangements on the measurement of profitability, including: – Features of the regulatory regime – profitability in any year can be impacted by various elements of the AER's regulatory process, such as smoothing of revenues via the PTRM and regulatory pass throughs" (ENA p3).	McN agree that revenue smoothing, pass throughs, timing of regulatory decisions and other factors may affect profit comparisons to varying degrees. However, it would be very difficult to try and adjust for these yearly fluctuations to make for example, the EBIT / RAB ratio perfectly comparable to the WACC in a given year. This would add unnecessary complexity and not result in complete accuracy in any case.

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5. Suggested adjustments to data – RAB adjustments "Because the RAB is required to be based on a depreciated replacement cost of the plant and equipment provided by the network, and where there is no requirement to devalue under or unused assets, this means that the RAB includes a considerable amount of inflation and the full value of assets even when they do not contribute to generating profits" (MEU, p3). "The key problem with this measure [EBIT/RAB] is that it does not appear to include the other source of return for the owner of the networks – the capital appreciation due to the indexation of the RAB" (CCP, p11). "The impacts of an overstated regulatory asset base (through inclusion of inflation)..... .... conspire to distort the "purity" of an EBIT/RAB comparison within the wider cohort of capital intensive firms operating in the market" (MEU, p5).	<u>Valuation basis for RAB</u> We agree that where the opening RAB did not closely approximate Deprecated Actual Cost ("DAC") at the time it was established, then RAB may not be comparable to the book value of assets (which may or may not have been revalued). Further, RAB and a statutory asset value may continue to diverge where revaluations are made for statutory purposes, but are not allowed for regulatory purposes after the opening RAB has been established. <u>Unused or devalued assets</u> We accept that the inability of regulated businesses to impair unused or devalued assets under the regulatory framework is an inconsistency with the accounting standards and rules governing impairment of assets for statutory accounts. However, it is very difficult to identify unused assets or assets that should be devalued. We do not consider that it would be viable to try and adjust the ratio analysis to reflect any unused assets or assets that should be devalued. <u>Indexation of the RAB</u> In accordance with accounting standards, assets may be revalued upward to reflect an increase in value, but they are not indexed for inflation. This is in contrast to the regulatory framework, which provides for the RAB to be indexed annually. We can therefore see issues with reliably comparing a return on a regulatory asset base that is indexed for inflation to a return on a statutory measure of assets that is not indexed for inflation. We consider that this issue could be addressed through the calculation of profitability measures based on the service provider's statutory account values of assets to allow comparisons of a service provider to firms in the broader economy.

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6. Return on Assets (EBIT) "Should only be calculated as EBIT/RAB, not EBIT/Total Assets" (AusNet p3). "The ROA (EBIT) ratio should be undertaken as a comparison of the forecast vs actual, with the forecast measure, and the calculation methodology, reported in the PTRM" (APA Group p8). "If the AER's intention is to provide meaningful insight into the actual profitability of NSPs then EBIT is not a useful measure. The only information we get from tracking EBIT as you propose is opex and depreciation variances" (CME, p1-2). "A return on asset metric might be appropriate for comparing the relative performance of similar businesses, but it would be inappropriate for comparing against the allowed return – because the return on asset measure is an ex post outcome over one year, whereas the allowed return is an estimate of the ex ante expected return that investors would require on average" (ENA p5). APA considers that a more relevant measure might be achieved WACC (after accounting for the effect of incentive mechanisms) relative to the allowed WACC)" (APA Group p13). APA notes that is similar to its suggestions for the Return on Assets (EBIT) "in each determination, the AER would set out benchmark profitability metrics in accordance with the regulatory allowance for the particular network business. Each business would then report outturn metrics on the same basis" (ENA p6). "For businesses operating under a revenue cap, any differences in EBIT based outputs (relative to the regulatory allowance) simply reflect outperformance driven by opex and / or against the service target performance incentive scheme. A benchmark version of any EBIT based metric,	Value of calculating statutory EBIT / Total assets We consider that there is value in developing a measure of EBIT / total assets for the service provider on a statutory basis, to enable comparison of returns to similar businesses operating in the broader economy. This is because the asset bases will be much more comparable (i.e. for both the service provider and the businesses in the broader economy the asset base will be determined in accordance with accounting standards). We acknowledge that this will not be a perfect comparison, as the service providers earn a mixture of regulated revenue and unregulated revenue. However, we have used the income statements provided in the electricity distribution RINs to assess revenue and EBIT from the core regulated service (standard control services for distribution) as a percentage of statutory revenue and EBIT for the service provider (noting that this is disclosed in the electricity distribution annual reporting RINs). We found that for the 2015-16 year, revenue for the core regulated service represented 74% of total statutory revenue for the service provider and EBIT for the core regulated service represented 77% of total statutory EBIT for the service provider. Given the above, it does not appear unreasonable to compare statutory EBIT / total assets for the service providers to statutory EBIT / total assets of businesses in the broader economy with a similar level of risk and capital intensity. We acknowledge that for some service providers, there may be difficulties in preparing statutory financial information. However, it is noted that the annual reporting RINs for the electricity distribution businesses and the annual reporting requirements for transmission businesses already require an income statement that shows statutory and regulatory figures, and illustrates the adjustments required to get from one to the other. We also note that up until 2012-13 for some electricity distribution businesses and 2013-14 for electricity transmission businesses, there was a requirement

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published as part of the AER's PTRM, would also facilitate like for like comparisons" (SAPN et al, p3).	for them to prepare a balance sheet on the same basis. Usefulness of regulatory EBIT / RAB as a profitability measure The businesses generally appear to support the regulatory EBIT / RAB profitability measure and a comparison to pre-tax WACC. CME argue that there may be limited value in comparing the EBIT / RAB ratio to the WACC, as it will simply show reasonable departures as a result of incentives, forecasting errors, timing variances and other minor variations. Whilst we accept that there is validity in CME's argument, we consider that there is still value in calculating the regulatory EBIT / RAB ratio. We consider that it is a useful comparator to other regulated electricity and gas businesses, and comparison of the regulatory EBIT / RAB ratio to the WACC may highlight where variances do occur (and allow further exploration of these variances). We would also note that as there does not appear to be a single perfect measure (and arguments for and against all measures put forward by the businesses, energy users and consumer groups), we consider there is value in multiple profitability measures being used.
7. Return on equity ratio (NPAT / total equity or NPAT on regulatory equity) "Any measure including equity will be problematic for consolidated businesses which raise capital at the corporate level" (APA Group p9). "in order to derive a meaningful measure, debt and interest would need to be based on allowed levels of debt and interest rather than some form of allocated interest from the corporate entity" (APA Group p9).	Allocation difficulties We acknowledge the difficulties that may be faced by a business in allocating interest and tax expenses to a service provider where it is part of a larger group. This may be because: – it is not currently required to be done; – the group may pay its tax at a group level and not determine tax at an individual business unit level; and – debt financing may be considered at a group level (and as a result interest paid at a group level) and not an individual business unit level.

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<tr><td>NPAT / Total equity is not comparable to the allowed return on equity and so should not be used to make such a comparison” (ENA p8).

”If required to report NPAT, businesses will be required to make a range of assumptions (e.g. allocate interest and tax costs to the regulated network level) that will limit the usefulness of the measures” (AusNet p1).

SAPN noted the following concerns:
– ”Accounting equity will not be comparable across businesses due to differences in gearing, and because debt (and hence equity) may not be apportioned across group structures.
– Accounting equity is not necessarily comparable to a regulatory benchmark efficient entity’s equity”
– It is not clear what the total equity denominator ought to be, as the assets are not traded”. (SAPN et al, p4).

”We consider that the data needed to calculate NPAT measures should not be added to the reporting requirements”.

”….balances and transactions are incurred at a company level, disaggregation into service classifications is not captured in AusNet’s existing processes or systems. Therefore, producing this data would require a range of assumptions…” (AusNet p4).

”it will be a technically complex task to allocate some items that are collected at a firm level to a particular regulated asset” (ENA p9).

”we consider data would preferably be only sourced from RINs already provided to the AER, after regulatory adjustments. This may require changes to current reporting, which does not always include regulatory adjustments” (SAPN et al, p4).

”Comparisons of return on equity with non-regulated businesses will be made more difficult</td><td>As a result, it may be difficult for some service providers to provide a statutory income statement that goes beyond EBIT to the net profit after tax level.

There also may be difficulties faced by a service provider that is part of a larger group in allocating liabilities and equity to the service provider. This could be because financing arrangements are made at a group level. Accordingly, it may be difficult for a service provider to provide a complete balance sheet.

There could also be further difficulty for a service provider to take the additional step of allocating interest, tax, liabilities and equity down to the core network service level (for example, standard control services in electricity distribution).

<u>Given the allocation difficulties, can it be done?</u>

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.

A significant reason for the resistance to the allocation of interest, tax, liabilities and equity by some businesses may be due to the likely increased cost that would be borne by service providers in producing this information. However, the extent of this cost and impact will vary across businesses.
It is important to note that 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.

We consider that for most service providers, either allocations could be readily made once guidance is put in place, or reasonable assumptions could be made to support the allocation of interest, tax, liabilities and equity to the service provider.</td></tr>
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by the effect of differences in gearing and the greater impact of differences in risk (compared to the impact of comparisons of EBIT/RAB). The value in the ROE measure may be in the examination of the reasons why it may differ from the EBIT/RAB measure. This may require additional data on actual interest and tax expenses" (CCP, p17). "The main measure that I suggest the AER should report is Return on Capital Employed. This is the net profit after tax divided by actual shareholder equity (not the AER's assumed 40%)" (CME, p2). CME also detail other adjustments required for this calculation. "MEU suggests that a secondary measure should be NPAT related to actual equity injection and this should be compared with that of the other firms in the cohort" (MEU, p5). MEU suggests "equity injection" should be the capital initially injected plus new injections plus retained profits.	For example, 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. As long as some commentary / explanation can be provided by the service provider to accompany the income statement and balance sheet, a reader of the information should be able to understand the potential issues in interpreting the results. It is acknowledged that problems may be encountered by service providers in gaining assurance over the allocations of interest, tax, liabilities and equity. However, if the AER can provide guidance on how a business should make allocations of interest, tax, liabilities and equity (and making estimates if required) it should be possible. Value of the ROE measure We also understand why consumers are interested in the return on equity measure, as it is an indicator of the ultimate return to shareholders / owners. It is informative to compare statutory ROEs for the service providers with returns earned by businesses in other regulated and non-regulated industries. This is particularly the case when ROE can be considered in the context of the risks faced by the service providers and the likelihood that future returns will deviate significantly from current returns. Are differences in equity levels an issue in making ROE comparisons

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	In accordance with corporate finance theory, a firm's managers will arrange the firm's financing structure in a way that maximises shareholder value (all else equal). This is commonly achieved where a firm carries a material amount of debt (due to its tax deductibility and other reasons). However, high debt is also generally considered to be a higher risk strategy, and a business owner may consider that it should earn higher returns on equity to compensate for this higher risk. High debt and low equity financing structures can be an indicator that the business has strong and stable earnings that allow it to comfortably meet the interest costs associated with the high debt. We do not consider that differences in equity levels prevents comparison of ROE's of businesses with different gearing. The ROE is the ultimate return on the investment of capital by business owners, and it can be argued that a business will adopt whatever financing structure they believe maximises returns, whilst balancing risk. Therefore, the ROEs can be compared without adjustments, although the reader of the information may take differences in gearing into account when interpreting the information. Does equity need to be traded to be valued? We do not consider equity needs to be traded to be able to be valued for the purposes of this ratio. If fact, we consider that the accounting value of equity is more appropriate, as it is commonly used as the denominator in this ratio. The market value of equity is often significantly different to the accounting value. Overall conclusion In McGrathNicol's original scoping study, the ROE measure was evaluated as less appropriate than others against Criteria 2 – calculation does not require significant manipulation of data. This recognised that some service providers that are

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	part of a larger group will have difficulty in determining the allocation of interest and tax. However, in balancing the challenges with the benefits, there appears to be merit in requiring businesses to allocate interest, tax, liabilities and equity to the service provider to enable the calculation of the statutory ROE. CME's suggested ratio CME have suggested use of a Return on Capital Employed Measure. It is our understanding that the generally accepted way of calculating return on capital employed is EBIT / total assets less current liabilities. The CME measure proposed appears to be a variant on the Return on Equity (NPAT). As discussed above, there appears to be value in calculating this ratio on a statutory reporting basis for the service provider (noting it is proposed that the Return on Regulatory Equity would be determined by applying the benchmark gearing to the RAB). However, to enable CME's proposed ratio to be calculated, service providers would need to allocate the equity section of the balance sheet to the three core components of equity: – equity injected; – retained earnings; and – revaluation reserves. This may be possible, but would add an extra level of difficulty for the service providers. The question is whether this would be worthwhile. We would argue that it is sufficient to calculate the ROE measure as proposed in our Scoping Study. We note that CME is seeking to remove the impact of asset revaluations from equity, but for the purpose of comparison to businesses in the broader economy it may be more consistent to include revaluations (which are allowed in accordance with accounting standards for businesses in the broader economy).

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8. Economic profit ratio "it will be necessary to establish a context against which this measure can be compared" (APA Group p10). "Economic profit is a dollar measure and so would not provide meaningful comparisons between firms of different size" (ENA p7). "Economic profit measures are subject to assumptions associated with the PTRM. For example, the pre-tax WACC component can be derived in the PTRM, but in the PTRM it will use the notional corporate tax rate of 30 percent. Actual tax, as the AER points out, is likely to be very different, and this will distort the measure" (SAPN et al, p4). "Economic profit compares EBIT to the pre-tax WACC*RAB. Thus, it is not a new or additional measure of profitability, but a means of benchmarking an existing measure (EBIT) against allowed WACC. It does however, introduce a new complication, the grossing up of the vanilla WACC to a pre-tax WACC" (CCP, p11).	As it is similar to the Return on Assets (EBIT) ratio, the economic profit ratio performed well against the criteria used for our Scoping Study. We included it as a secondary ratio as we thought it might be able to help illustrate the return compared to the benchmark by showing it as a positive (outperformance) or negative (underperformance) dollar figure. However, we note that submissions indicate that stakeholders do not consider that the economic profit ratio would add any additional value. We agree that the economic profit ratio does not provide significant new analysis in addition to the Return on Assets (EBIT) ratio.
9. Operating profit per customer "APA is not clear as to what the AER is seeking to report with this measure, or what behaviour would be encouraged by shippers based on the level of this measure" (APA Group p 10). "Operating profit per customer is subject to comparability issues and would not provide meaningful insights" (ENA p7). "this measure is unlikely to provide sensible comparisons between businesses even in the energy sector. There is considerable variability between businesses of the same type, such as electricity network distribution businesses in metropolitan or rural areas" (SAPN et al, p4). "it is unclear how this comparison will be any more meaningful than simply comparing trends	We consider that the operating profit per customer measure has value. It is an easy to calculate and easily understood measure. As EBIT is used, it will measure profitability before the impact of interest and tax. In addition, it may be a useful measure to show changes in profitability where EBIT is not changing but customer numbers are, and where growth in EBIT exceeds the growth in customer numbers.

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in EBIT. Year to year changes in this measure are largely driven by changes to EBIT. Changes to customer numbers or connections will generally change by small amounts" (SAPN et al, p4). "Operating profit per customer is an easily understood measure of the profits coming out of the customer's pocket, but is of limited value for regulatory decision making. Comparisons would need to be limited to comparisons between energy network businesses or businesses with similar asset intensities and turnovers" (CCP, p12).	
10. Single versus multiple performance measures "APA considers that Return on Assets (EBIT) is the only proposed measure that will allow users to compare outcomes against the forecasts in the AER's regulatory determination" (APA Group p10) "reporting against a single measure will also assist stakeholders to understand the results, including how they compare across businesses" (SAPN et al, p5). "The MEU considers that having just one measure to assess network profitability will be insufficient for the needs of the AER and stakeholders, and that a number of profitability measures would be more appropriate to identify if there is excessive profitability" (MEU, p5). "All measures of profitability are likely to be imperfect in some way and better suited for purposes than others. Consequently, it will be necessary to consider a range of measures, with some being given more weight for some purposes but less weight for other purposes" (CCP, p8). "[Newgrange identifies that] to obtain comparisons with other sectors a wider array of metrics will likely be required" (ECA, p6).	We maintain the view from our Scoping Study that the use of multiple measures can be valuable, as they can highlight different aspects of what is driving profitability outcomes. Given that there appears to be no single perfect measure, the use of multiple measures would appear to be prudent.

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<tr><td>11. Different measures for different sectors

”the key difference will be whether the business is regulated under a price cap or a price revenue cap regime, and the differing incentives under these two regimes” (APA Group p12).

”Because industry characteristics and regulatory frameworks are, at a high level, similar across all sectors / segments, we consider that the same EBIT based metrics can be used for each sector and segment .... However, the most robust comparisons will be between businesses in the same sector” (AusNet p5).</td><td>We consider that it is reasonable to use the same profitability measures for all service providers.

Whilst we acknowledge there are some differences between electricity and gas, and distribution and transmission, all the business have a number of key elements in common, in that they:
– are regulated, and allowed to earn a return on a regulatory asset base;
– have similar levels of risks; and
– have a similar level of capital intensity.

We consider that the businesses are sufficiently similar that the same suite of ratios can be used.

The only exception to this would be the operating profit per customer ratio. As transmission businesses have very few customers, this ratio is not likely to be meaningful at the transmission level.</td></tr>
<tr><td>12. Other suggested performance measures – RAB multiples

”RAB multiples (i.e. market value / RAB) should be included in the profitability measures considered by the AER. RAB multiples provide the most direct information available on the relativity of allowed and expected returns on capital or equity, and are easily observed at the time of transactions” (CCP, p13).

”Market value / RAB (or Book Value) is also a simple measure that is widely used by investors and regulators. For regulators, it can provide an indication of the relativity of the allowed ROR and investors required ROR. Hence, it can be used as a cross-check on the ROR proposed but it requires:
– Further analysis to ‘peel away’ the additional sources of value; and
– Consideration of multiple observations to identify if there is a systematic pattern for RAB multiples significantly larger than 1” (CCP, p6).</td><td>The submissions supporting the use of RAB multiples have highlighted the challenges of using them.

While we stand by the disadvantages of RAB multiples we raised in our Scoping Study, we acknowledge that when there are observable transactions or market values for the regulated businesses, there is merit in capturing and presenting this data in a profitability measures framework. However, we believe that they can only be used for regulated businesses (and cannot be compared to non-regulated businesses), are only relevant for a period of time following the transaction and become less relevant as time passes (for non-listed firms), may reflect multiple RABS (for listed firms) and may be infrequently available.</td></tr>
</table>

Concern / issue	McGrathNicol response
"The weakness of the RAB multiple is that further analysis is required to make the best use of the information on the relativity of expected and actual return" (CCP, p13). "At the time of transaction, it [RAB multiple] is simply the sale value divided by the RAB. It is accepted that this measure will at best provide occasional benchmarks and / or partial coverage of the sector" (CCP, p17).	
13. Other suggested performance measures – IRR "The IRR should be reported for comparison to New Zealand networks as should financing ratios" (ECA, p7).	Although the calculation of an IRR may enable a simple comparison to the WACC, application of the New Zealand calculation of IRR would require a significant amount of data to be provided by service providers which is not currently provided, and adjustments to RIN data in order to derive required data inputs for the calculation. However, whilst the regulatory accounts are not publicly available for the New Zealand electricity distribution business, statutory accounts are. Accordingly, we consider that there is value in the returns of the New Zealand businesses being compared against the returns of the Australian service providers. In our view the appropriate comparison would be based on the statutory ratios for the Australian and New Zealand businesses.
14. Audit requirements "APA questions the need for businesses to report a complete Balance Sheet" (APA Group p14). "It is important to consider whether it is reasonable to expect regulated businesses to prepare financial statements in accordance with the Australian Accounting Standards when the profitability measures to be reported will be based on a different foundation" (APA Group p14).	Current audit requirements for distribution businesses The RIN financial information is currently required to be audited unless the information is: – Audited Statutory Accounts (the audited set of Statutory Accounts for the entity as a whole prepared in accordance with ASIC requirements); – forecast information; – estimated information; or – explanations relating to material differences.3

[3] Regulatory Information Notice under Division 4 of Part 3 of the National Electricity (State) Law, Appendix D, section 1.1(a).

Concern / issue	McGrathNicol response
"Costs will be incurred to produce and have audited the financial statements required to produce NPAT level data, which are ultimately borne by customers" (AusNet p1).	We note that estimated information is defined as information presented in response to the RIN whose presentation is not materially dependent on information recorded in the service provider's historical accounting records or other records used in the normal course of business, and whose presentation for the purposes of the RIN is contingent on judgements and assumptions for which there are valid alternatives, which could lead to materially different presentation in the response to the RIN. The audit: – must comply with Auditing Standard ASA 805 [Special considerations] – Audits of single Financial statements and specific elements, accounts or items of a financial statement; and – must include an opinion as to whether or not the financial information provided is presented fairly in accordance with the requirements of the Notice including the principles and requirements in Appendix A.4 Current audit requirements for transmission businesses The information guideline for transmission NSPs requires regulatory information submitted to the AER to be audited. The audit must: – be prepared in accordance with Australian Auditing Standard AUS 802 – The Audit Report on Financial Information Other than a General Purpose Financial Report; – clearly express the auditor's opinion whether the financial information is presented fairly in accordance with an identified financial reporting framework. Suggested audit requirements Auditing standard ASA 805 may be appropriate to apply to financial information collected from the service providers. The reasonable level of assurance

[4] Regulatory Information Notice under Division 4 of Part 3 of the National Electricity (State) Law, Appendix D, section 3.2.

Concern / issue	McGrathNicol response
	required by ASA 805 appears to be consistent with what is currently required of distribution and transmission businesses. However, we consider the current exception for estimated information to not be audited in the annual reporting RIN guideline should be removed. We understand this would be consistent with the treatment of estimated information in the AER's economic benchmarking and category analysis RINs. We consider the estimation of some information is likely to be required when preparing the income statements and balance sheets for service providers. As such, in order for users of the information to have confidence that the service provider's income statements and balance sheets present fairly, it is likely that estimated information is required to be audited or reviewed.
15. Financeability metrics "ENA submits that financeability metrics (i.e. those metrics used by rating agencies to assess the credit worthiness of business) should be considered as part of the AER's process for setting the allowed return of capital. Hence no additional metrics are proposed for consideration under the AER's Profitability Measures process" (ENA p10). "AER should consider using other profitability measures, such as financeability analysis and sensitivity analysis for the return on equity, as done by some regulators (such as OfWat and Ofgem). Such measures should be a cross check, rather than a determinant of the ROR or revenue requirement" (CCP, p19). "It would be helpful for the AER to publish information on dividends and shareholder loans. Such actual cash transfer data will be helpful in providing a clear picture of actual network service provider profitability and financial capacity" (CME, p2).	Not relevant to profitability measures. Both profitability and financeability metrics are included in the broader concept of a financial performance measure. However, compared to profitability measures, financeability metrics are more related to the financial viability or sustainability of a business. A regulator may consider using financeability tests to explore the impact of revenue determinations, i.e. whether a decision would result in a business having sufficient cashflow or difficulty in meetings its debt obligations. Whilst there may be a correlation between strong performance against financeability tests and profitability, financeability tests do not readily illustrate the level of profitability, whereas a profitability measure will.

Disclaimer

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The information in this letter may not include all possible or relevant information in relation to the matter we have been instructed to review. Whilst every effort has been made to ensure the information contained in this letter is accurate, McGrathNicol accepts no responsibility if the information ultimately turns out to be incorrect or not applicable. We note that, in issuing this letter, McGrathNicol is not certifying that we have identified all relevant information. We have sought to identify all relevant information but provide no assurance that all such information has been identified.

Contact

Should you wish to discuss any aspect of the above, please contact Richard Greig or Michael Dunnett on (02) 6222 1400.

Yours sincerely

McGrathNicol Advisory

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