

## Meeting summary—26 June 2019

### Key issues and action items

**TO:** Profitability Measures Review Working Group (PMRWG)

**CC:** Warwick Anderson

**SUBJECT:** Summary of outcomes from the PMRWG meeting 26 June 2019

The PMRWG met on 26 June 2019 as part of its ongoing engagement to work through issues raised in response to the AER's draft position paper for the review into profitability measures that can be applied to electricity and gas network service providers (NSPs). The agenda was:

1. Introduction
2. Further guidance on use of the measures
3. Inclusion of incentive scheme impacts in the profitability measures
4. Earnings per customer numbers (or connections) profitability measure
5. Next steps

For agenda items 2 to 4, AER staff (we) provided a summary of its draft position paper on the issue, presented stakeholder views in response to the draft position paper, and put forward its own views for discussion. For the latter, we put questions to the PMRWG to help guide the discussion. The following is a summary of the outcomes of this meeting.

#### Introduction

We provided a summary of the review to date and set out the forward work plan, key issues for discussion and the indicative timing of the PMRWG meetings for 2019.

#### Further guidance on use of the measures

We noted concern was raised that the profitability measures could be used in an arbitrary or unpredictable manner and that guidance be provided on how they would be used by the AER and to guide interpretation by readers. In terms of guidance, the submissions proposed:

1. The AER provide explanations/commentary when reporting the measures.
2. Establishing mechanisms to address variability and one-off events.
3. Development of principles that provide clear expectations on the measures use.

We proposed that most stakeholder concerns would be addressed by the AER publishing detailed explanations and commentary when reporting the measures so as to minimise ambiguity in interpreting the measures. To this end, we proposed to:

- if published as standalone measures - publish explanatory notes to provide guidance as to how the measures are constructed and the key factors that should be taken into consideration when interpreting the measures (consistent with those that accompanied our publication of the return on assets (ROA) measures in October 2018, or

- if published in NSP performance reports - include detailed analysis of drivers of profits supported by the clarification on how to interpret the measures (including the appropriate comparators) and any relevant caveats to provide the appropriate context.

We proposed that publishing explanations and commentary would alleviate the need to introduce mechanisms to address profit variability or one-off events. Further, we proposed not to develop specific principles around the use of the measures but rather that the final position paper will reinforce the draft position paper that:

- it is not the AER's intention at this time to use the measures to directly make adjustments to regulatory determinations of individual network businesses, and
- the measures will be used to observe the level of profitability of NSPs and to identify the drivers of these profits to provide context to regulatory determination processes.

The final position paper will also note that the profitability measures will be used as an additional source of information as to the overall effectiveness of the regulatory regime. Where profitability across the sector level is higher (or lower) than expected, we may initiate a review of the factors contributing to the high (or low) level of profitability. This is to ensure the regulatory framework is achieving the desired outcomes under the NEO and NGO.<sup>1</sup>

#### **For discussion:**

- Does the working group agree that most of the stakeholder concerns would be addressed by the AER providing explanations and commentary when reporting profitability measures to reduce ambiguity in interpreting the measures?
- Does the working group support the publication of explanatory notes to provide guidance when the AER publishes the measures on its website?
- Does the working group consider explanatory notes, consistent with those published with the ROA ratios, provide appropriate guidance to stakeholders?
- The publication of explanatory notes and supporting commentary will identify 'natural' variation introduced in the regulatory framework (such as revenue under and over recovery arrangements). Does the working group think this will alleviate the need to introduce mechanisms to address profitability variability?
- Does the working group agree with the AER's proposal to not develop specific guiding principles around the incentive framework? Have we justified our position on this sufficiently?

#### *PMRWG considerations*

The PMRWG supported the proposal that provision of detailed explanations and commentary on measures and their limitations would mitigate the risk of misinterpretation and would alleviate the need to introduce mechanisms, such as smoothing, to address profit variability.

To this end, the PMRWG considered this explanatory material should be prominently featured to guide interpretation of the measures. It will be especially important to have a clear link between any presentation of the data (including spreadsheets) and the explanatory material.

The PMRWG requested that NSPs be provided the opportunity to comment on the measure results prior to publication. The NSPs' feedback could be used to inform the AER's reporting.

The PMRWG raised concerns about use of profitability results to review aspects of the regulatory regime as the results will be reliant on 'lagged' information which may not factor in updates to guidelines and regulatory approaches.

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<sup>1</sup> NEL, s. 7; NGL, s. 23.

### Action Items

- There were no action items from this agenda item.

### **Inclusion of incentive scheme impacts in the profitability measures**

We put forward the view that, where applicable, the profitability measures be reported both inclusive and exclusive of incentive scheme revenue impacts to increase the transparency of the impact of these schemes on NSPs returns. Further, we proposed that:

- supporting data be published, including a disaggregation of the NSPs incentive scheme rewards and penalties as stakeholders have requested this information, and
- explanatory material accompany the publication of the measures and data to highlight the appropriate comparator of the measure (e.g. pre-tax real WACC) and provide clarification on how to interpret the measures.

We noted the proposed approach was consistent the approach the PMRWG supported for the publication of the return on assets (ROA) measures and data in October 2018.

#### **For discussion:**

- Does the working group agree that the measures be reported both including and excluding incentive scheme impacts in the interest of transparency for stakeholders?
- Does the working group agree with publishing disaggregated NSP incentive scheme payments and penalties as stakeholders have requested this information?

### PMRWG considerations

The PMRWG supported the proposal to report the measures (where applicable) both inclusive and exclusive of incentive scheme impacts as well as publication of disaggregated supporting data. However, PWRWG noted the approach may need further consideration for the return on regulatory equity measure as adjustments for incentive schemes will affect after tax positions.

The PMRWG also suggested the AER's final position paper and/or explanatory material could do the following to guide the interpretation of the profitability measures:

- highlight that incentive schemes are part of an overall incentive based regulatory framework which encourages NSP's outperformance for financial gain—that is, there are other 'incentives inherent in the framework but which are not captured or compensated through the schemes, and
- include a clear statement on the operation of the individual incentive schemes and any differences across schemes and/or jurisdictions.

### Action Items

- AER staff to provide the PMRWG with further clarification on the treatment of incentive scheme impacts for the reporting of the return on regulatory equity measure.

### **Earnings per customer (or connections) profitability measure**

We proposed to maintain the draft position that earnings per customer be included in the suite of measures to be reported. Earnings per customer, unlike the other measures, is not directly influenced by asset base size and therefore highlights a different aspect of profitability.

In response to concern that the measure could be misinterpreted, we proposed that when reporting the measure to qualify the conditions over its calculation and the limitations of its comparability given the NSPs' different profiles of customer types and network characteristics. It was noted that the primary benefit of reporting earnings per customer numbers is that it provides a good comparison of an individual NSP's profitability against its previous outcomes.

We set out a proposed calculation method and questioned whether the measure would be more informative as earnings per customer numbers or per connection. Further, whether the measure be calculated by total number or by sub-groups of customers or connections.

We also proposed to maintain the draft position view that transmission NSPs not report against this measure given it is more suited to NSPs that have a large number of connections.

#### **For discussion:**

- Does the working group agree with reporting EBIT/customer numbers or connection numbers to highlight a different aspect of profitability as all other measures include asset or equity values in the denominator?
- What are the working groups considerations as to whether presenting the measures by customer group (residential, commercial, industrial) would provide more meaningful measures?
- Does the working group agree that transmission NSPs not be required to report against this measure given it is more suited to NSPs that have a large number of connections?
- Does the working group agree with AER staff's proposed method for calculating this measure using customer numbers rather than customer connections as the denominator?

#### *PMRWG considerations*

The PMRWG supported the reporting of 'simple' EBIT per customer numbers (rather than per connections or by sub-groups) measures with supporting commentary to qualify the calculation and interpretation of these measures. PMRWG considered supporting data including customer type and customer location could be used to support the commentary.

The PMRWG noted the concern about stakeholders misinterpreting the measure and in particular reflecting the network proportion of customers' bills. To this end, PMRWG emphasised the importance of clear qualifications to guide stakeholders' interpretation/use of the measures. The PMRWG also considered how characteristics of the networks (such as customer density) might best provide context for the results.

The PMRWG generally supported the proposed calculation method but requested further detail to assist in understanding/working through some of the particulars. The PMRWG also considered further detail on the method to calculate the measure could assist in exploring the application of measure to transmission NSPs using aggregate of customer numbers.

#### *Action Items*

- AER staff to provide PMRWG examples (distribution and transmission) of calculated measures and commentary for next working group discussion.

#### **Next Steps**

The PMRWG would meet again in early August to discuss issues raised in regard to the RAB multiples measure and further discussion on EBIT/customer numbers.