Meeting summary—8 August 2019
Key Issues and Action Items

TO: Profitability Measures Review Working Group (PMRWG)

CC: Warwick Anderson

SUBJECT: Summary of outcomes from the PMRWG meeting 8 August 2019

The PMRWG met on 8 August 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. Opening remarks / update on work program

2. RAB multiples profitability measure

3. Earnings per customer numbers (or connections) profitability measure

4. Amendments to the unders and overs arrangements text in return on assets explanatory statement

5. Next steps

For item 2, AER staff provided a summary of its draft position paper, presented stakeholder views in response to the draft position paper, and put forward its own views for discussion. For items 3 and 4, AER staff put forward its views on issues raised by the PMRWG which required further consideration. For agenda items 2 to 4, AER staff put questions to the PMRWG to help guide the discussion.

The following is a summary of the outcomes of this meeting.

Opening remarks / update on work program

AER staff (we) provided an update on the forward work plan, key issues for discussion and the indicative timing of PMRWG meetings.

RAB multiples profitability measure

We proposed to maintain the draft position that RAB multiples be included in the suite of profitability measures to be reported. RAB multiples, unlike the other measures, may provide insights into expected returns. As previously noted, the reporting of a suite of measures is considered superior to reporting just a single measure as it will highlight different aspects of profitability and allow a more comprehensive assessment of the drivers of profit.

Calculation and application

RAB multiples are calculated as the market (enterprise) value of the NSPs relative to their asset bases. Information on market values can be obtained at the time of a sale of the business (transaction multiples) or based on the value of a company's shares (trading multiples).

We noted the AER maintains a database of reported RAB multiples from the sale of network assets and will add to this RAB multiples from future sales/transactions and trading multiples when they become available. It is proposed that this information be presented alongside other measures of profitability in the AER's performance reports.

As new multiples are added, we proposed to publish explanatory detail about the new transaction and circumstances of the asset and/or the sale. It was noted that unlike the other proposed measures, reporting on RAB multiples would not require the NSPs to provide data.

We proposed that RAB multiples for both transaction and trading multiples be sourced from credible market analysis rather than be calculated by the AER. However, if availability becomes an issue, we would revisit development of its own estimates.

For transaction multiples, it was put forward that relevant RAB multiples from both within and outside the AER's regulatory regime be included in the analysis (namely electricity and gas networks in both Australia and New Zealand). Our view was that these transaction multiples provide useful further context to assist in the interpretation of domestic multiples.

For discussion:

- Does the working group agree that the AER report both trading multiples from within and outside the AER's regulatory regime?

- Does the working group agree that the AER rely on estimates of transaction multiples over time from well-regarded market experts or generate its own estimates?

- Does the working group have any views about method or data sources for generation of our own RAB multiples?

Considerations for discussion—issues raised in submissions

We noted submissions to the draft position paper put forward the following varying views as to whether RAB multiples be included in the suite of profitability measures to be reported on:

- RAB multiples are not suitable for regular reporting because:
  - they are not available for all NSPs
  - transactions are infrequent which diminishes their usefulness as a specific transaction multiple will only be relevant for a period of time, and
  - they reflect investors' forward looking expectations and not a representation of historical performance.

- Both trading and transaction multiples be published to balance out that different factors influence the different types of multiples.

- Competing views on whether RAB multiples can/should be decomposed for reporting.

- The risk of circularity if RAB multiples are used as an influence for the determination of a specific regulatory input, such as the rate of return.

Taking these views into consideration, we proposed to report both trading and transaction RAB multiples. As with all the proposed measures, the expectation is they will have strengths and weaknesses, and that consideration of context will be important in their interpretation.

In response to views that RAB multiples are not suitable for reporting, we acknowledged that neither transaction nor trading multiples are available for all NSPs and the infrequency of transaction multiples is a limitation on their standalone usefulness for reporting. However, while all short-comings could not be overcome, we noted:

- the periodic information on transaction multiples can be supplemented with ongoing information from trading multiples, and

- where they do occur, transaction multiples may provide useful additional context in considering trends in the suite of profitability measures.

We also acknowledged that RAB multiples are forward looking and that, in this respect, are distinct from the other proposed measures. However, RAB multiples remain relevant to the consideration of performance reporting because:

- forward looking perceptions of performance relative to regulatory settings would be informed to a material extent by the evidence of that performance historically, and

- forward looking expectations at a historical point in time may serve as useful context in consideration of whether investors perceive contemporaneous performance data trends as transient or ongoing.

In response to views on decomposing RAB multiples, we were not persuaded at this time either that it is unachievable to draw reasonable inferences about the materiality of various factors, or that it is essential to decompose RAB multiples precisely in this context. As such, we proposed not to seek to precisely decompose RAB multiples into sources of value. Nonetheless, where analysis over time shows evidence of sector-wide trends, this may serve as a trigger for deeper investigation of factors that might coincide with those trends.

In response to the risk of circularity of RAB multiples influencing building block revenues, we acknowledged there would only be risk if they were used as a repeated and determinative influence for a specific regulatory input, such as the rate of return. However, this risk is limited for network performance reporting where RAB multiples will be considered amongst a suite of measures to serve as an overall 'health check' on the performance of network regulation.

Further, to the extent that RAB multiples amongst the other performance reporting measures serve as a trigger for further investigation of specific profit drivers, this investigation would be accompanied by reliance on primary information to those drivers.

For discussion:

- Does the working group consider that the AER needs to decompose the multiples precisely to draw useful inferences from them?

- What role can intermittently available transaction multiples play in our performance reporting?

- What does the 'forward looking' nature of RAB multiples mean for their role in performance reporting?

RAB multiples—Draft explanatory material

We noted the consideration of context will be important in the interpretation of RAB multiples. To this end, we provided draft explanatory information which we intend to publish when reporting on RAB multiples. In summary, this information:

- Set out a definition of RAB multiples, the different types (transaction and trading multiples) and the implications that should be taken into account in interpreting them.

- Recommended stakeholders also read Dr Darryl Biggar's paper 'Understanding the role of RAB multiples in the regulatory process' for background on the theory of RAB multiples, and provided a link to this paper.[1]

- Noted the proposed sources for reporting RAB Multiples (credible market experts).

- Provided guidance on how to interpret RAB multiple values (in particular values above one) including the factors that can influence these values.

For discussion:

- Does the working group have feedback on the draft explanatory material?

- Should we refer in the material to the 0.9 to 1.3 band of expected RAB multiples as set out in Dr Biggar's paper (p11) to guide readers as a trigger for further exploration?

PMRWG considerations

PMRWG members largely supported the reporting of RAB multiples (both transaction and trading multiples) as another measure of the NSPs profitability. However, PMRWG members highlighted that further contextual analysis would be important if using RAB multiples to compare NSPs to other non-regulated businesses as they face different drivers and risks.

There was also support for the measures to be sourced from market analysts. However, some PMRWG members questioned whether the assumptions that underpin these RAB multiples would be transparent. For example, it was unclear whether these analysts used the 'book value' of assets rather than the values of regulated assets in determining trading multiples which would impact their direct relevance to the regulatory framework. AER staff committed to seeking further information on this. PMRWG members also queried whether additional data would be available to isolate the effect of regulation in these outputs.

It was also noted that RAB multiple values greater than 1 can occur for a number of reasons beyond 'outperformance' and there is a risk that values above 1 could be misinterpreted. It was raised whether further guidance be provided to assist with the interpretation, such as:

- developing reasonable ranges using comparators from other sectors (e.g. defensive stocks— especially businesses high in physical capital), or
- use of other research (including a recent NBER working paper on valuing intangible assets, in addition to Dr Biggar's paper) as a guide of reasonable RAB multiple values.

PMRWG members:

- requested the AER to investigate the considerations it raised in regard to RAB multiples for the final positions paper.
- suggested further edits to the proposed explanatory material.

Action Items

- AER to investigate the considerations raised by the PMRWG in the meeting.

- AER to update explanatory statement to reflect discussion at the meeting.

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[1]   Available here: https://www.aer.gov.au/system/files/AER%20-%202018%20RoR%20Guideline%20Review%20-%20The%20Role%20of%20RAB%20Multiples%20in%20Regulatory%20Process.pdf

Earnings per customer profitability measure

At the 26 June 2019 working group meeting, it was agreed that we would provide the PMRWG with some illustrative earnings per customer results for discussion. This serves to highlight:

- some of the methodological issues which might arise in developing the metrics, and

- analytical tools that we might use in the reporting to aid interpretation.

To progress the discussion, we set out:

- our proposed methodology for calculating earnings per customer

- an example of some of the AER's preliminary analysis using this measure, and

- draft explanatory material on the earnings per customer measure.

Methodology for calculating earnings per customer and results of the preliminary analysis

We set out our proposed method to calculate the earnings per customer profitability measure and the results of some preliminary analysis we had undertaken.

The method set out:

- the calculation we intend to use, and

- the detailed aspects of the inputs we used for our preliminary analysis including the treatment and sources of revenues and expenditures to calculate earnings before interest and tax, the use and source of incentive scheme payments/penalties, how customer numbers had been derived and approach to the consumer price indexation.

We presented preliminary analysis for electricity distribution NSPs to illustrate the types of analysis that we can present to:

- draw inferences about performance of the network regulatory regime, and

- assist with interpretation of the measures—or, conversely, mitigating the risk of misinterpretation.

This analysis included the impact of network characteristics, trends with baseline variation normalised and the impact of customer numbers.

For discussion:

- Does the working group have any feedback on the preliminary analysis, including with respect to:

    o preliminary impressions of the initial estimates;

    o whether it can be readily interpreted;

    o whether our additional analysis (graphical presentations and network characteristics) assist with interpretation of the measures; and

    o whether there are any other factors that might inform the high annual variability in metrics

- Does the working group agree in principle that jurisdictional schemes and cross boundary revenue be included in EBIT when calculating profitability measures?

Application of the measure to transmission NSPs

At the 26 June 2019 working group meeting, we noted that consistent with our draft position paper our view was that transmission NSPs would not be required to report earnings per customers as this measure is more suited to NSPs that have a large number of connections.

However, at that meeting, the PMRWG suggested that further detail on the approach to calculate the measure could assist in exploring the application of measure to transmission NSPs using aggregated customer numbers.

To inform this discussion, we developed a method and analysis based on electricity transmission NSPs. The transmission NSPs customer numbers were created by aggregating customer numbers from distribution NSPs operating in the relevant state for each transmission network. The analysis excluded direct connect customers to the transmission networks.

The analysis also excluded interconnectors.

For discussion:

- Does the working group agree that interconnectors should not be required to report against this measure?

- Does the working group agree that the methodology to calculate TNSPs earnings per customer provides contributes meaningful metric?

Earnings per customer—Draft explanatory material

As with RAB multiples, we provided draft explanatory information on earnings per customer which we intend to publish when reporting the measure. In summary, this information:

- set out the context of the earnings per customer profitability measure

- noted the method that would be used to calculate the measures, and

- provided some factors that should be considered when interpreting the earnings per customer outcomes, including cost pass throughs and jurisdictional schemes.

For discussion:

- Should we publish an explanatory statement along these lines alongside data and reporting on the earnings per customer measure?

- Do working group members have any feedback on the draft statement above?

PMRWG considerations

PMRWG members largely supported the proposed method for determining the earnings per customer measure for distribution NSPs. There was consensus that amounts unrelated to regulated services should be removed from the calculation.

There was also discussion about whether or not to adjust income statement reporting to ensure consistency between jurisdictions. PMRWG members identified a balance between:

- improving consistency between NSPs, and

- avoiding adjustments where possible because they can compromise clarity and transparency in the data.

On the preliminary analysis, the PMRWG discussed the differences between different NSPs. Members made several recommendations based on the presentation of this data:

- Even with supporting information, the material differences in EBIT per customer when compared between NSPs will be difficult for stakeholders to interpret correctly.

- Information from the AER's benchmarking reports could be used to highlight relevant network characteristics which can affect differences in EBIT (e.g. customer density etc)

- While this additional information is important, it is also important not to overcorrect or to imply that none of the differences between networks was driven by legitimately different profitability.

Based on the preliminary analysis, the PMRWG were of the view that meaningful earnings per customer measures could be reported for transmission NSPs. However, they reiterated concerns that:

- some customer classes (eg large customers) are likely to contribute a higher proportion of EBIT than customer numbers, so

- it is likely that a uniform earnings per customer estimate will overstate the 'true' measure for some customer groups and understate it for others.

Further, there was discussion of whether the measure would be workable for gas transmission NSPs due to their customer bases which, in some jurisdictions, are made up of a smaller number of large customers. Overall EBIT per customer may be materially different between jurisdictions because of the different composition of customer types.

Consideration of whether interconnectors should report against the measure was not resolved.

PMRWG members recommended some revisions to the explanatory statement to better explain the effect of different customer profiles and in particular the effect of large customers on the measure if transmission NSPs were to report on the measure.

Action Items

- Further review application of the measure to transmission NSPs with the inclusion of directly connected customers to the transmission network.

- Seek resolution on excluding interconnectors from reporting against the measure.

- Revise explanatory statement to reflect the discussion at the meeting.

Amendments to the return on assets explanatory statement

Following the 26 June 2019 PMRWG meeting, edits were proposed to the 'unders and overs' arrangements wording in the return on assets (ROA) explanatory statement. It was suggested the current wording assumes readers have a greater knowledge of how the revenue cap mechanism operates than may be the case. While it noted the NSPs actual revenues never match their target revenues, it does not make clear that NSPs only ever recover their allowed revenue over time. Revisions to the text were proposed to make this point clearer.

We agreed that further clarity on the operation of the revenue cap within the unders and overs arrangements text in the ROA explanatory statement would assist the interpretation of the ROA outcomes. We put forward our own proposed edits for consideration of the PMRWG.

> **For discussion:**
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> - Does the working group agree with the proposal that the ROA explanatory statement be amended to provide greater clarity on the operation of the revenue cap so as to better assist readers in interpreting the profitability measure outcome?
> - Does the working group support the AER's proposed text for this purpose?

PMRWG considerations

PMRWG members supported the proposed amendments to the ROA explanatory statement, but for some minor editorial changes.

Action Items

- AER to update the ROA explanatory statement to reflect the agreed edits.

Next Steps

The PMRWG would meet again in late August/early September to discuss issues raised in regard to the return on regulatory equity measure.