8 December 2017

Ms Kaye Johnston
Director, Network Finance and Reporting
Australian Energy Regulator
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Via: AERinquiry@aer.gov.au

Dear Kaye

Discussion paper: profitability measures for regulated network businesses

Overview

Citipower, Powercor, United Energy, SA Power Networks and Australian Gas Infrastructure Group (the Businesses) provide electricity and gas distribution and transmission services to around 4 million customers in Victoria, South Australia, New South Wales, Queensland, Western Australia and the Northern Territory. Together, we have investment in infrastructure assets of over $18 billion.

We welcome the opportunity to engage with the AER on potential measures for assessing the profitability of regulated network businesses. In particular, we support further consideration of:

- the intended use of profitability measures in incentive-based regulation; and
- the meaningfulness of actual return to equity measures in the context of how the AER sets allowed returns to equity.

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.

These issues are discussed in detail below.

Role of profitability measures in incentive regulation

In its discussion paper, the AER recognised that neither the National Electricity Rules nor the National Gas Rules require profitability to be considered when setting annual revenue requirements. Instead, the regulatory framework provides incentives for businesses to outperform regulatory benchmarks. This is achieved through focusing on costs, as ultimately, any outperformance is a positive outcome of the regulatory framework that is shared with customers.

Meaningfulness of actual return measures

The AER does not explicitly consider evidence from actual returns to equity when setting the allowed return on equity (arguing that expected and actual returns contain different information). On this basis, it has resisted calls from service providers to make more use of evidence from actual returns in the context of its foundation model approach.[1]

The merits of this approach are a topic for the broader rate of return guidelines review, but in the context of this review, there is a potential inconsistency. That is, if the AER considers actual returns contain different information to expected returns for the purpose of setting the rate of return, it should not draw meaningful conclusions from comparisons between actual and expected returns when assessing profitability.

<u>The need for a like-with-like comparison</u>

If the AER collects some measure of actual profitability, it is vital it has a relevant benchmark of the same metric. Otherwise there is no basis on which to compare actual returns against allowed returns. Thus, if the AER deems EBIT/RAB is an appropriate measure of actual profits, in its final decision for a given company, it would preferably also publish a benchmark version of the same metric (for example, in the post-tax revenue model).

For clarity, we do not suggest the AER 'determine' an EBIT/RAB measure in the same way it determines, say, the WACC. Instead, we simply propose the 'benchmark' EBIT/RAB as an out-turn measure from all of the other relevant parameters in the final decision of each business.

<u>Avoidance of regulatory circularity</u>

There is a danger in regulation of circularity, where results are driven by regulatory assumptions and those results are used to validate those assumptions or regulatory decisions. Information from outside the regulatory sector, therefore, may provide a cross-check that regulated returns are commensurate with those earned by businesses with a similar level of risk operating in a competitive market.

<u>Response to AER questions</u>

We agree with the AER that EBIT/RAB is the most appropriate measure (as long as regulatory assumptions are reflected), but note there may be scope for simpler measures tracking opex. We expand on this, and respond to the AER's questions in the appendix attached to this submission.

Should the AER have any questions on this submission, please contact Nick Wills-Johnson on (08) 9223 4902.

Kind regards

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General Manager Corporate Strategy

Renate Vogt
General Manager Regulation

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1 AER, *Draft Decision Multinet Gas Access arrangement 2018–2022: Attachment 3 – Rate of return*, July 2017, pp 62-64.

Response to the AER's questions

1. Do you agree with the preferred profitability measures? If not, what other measures do you consider should be reported by the AER and why?

<table>
<tr><th>Measure</th><th>Comments</th></tr>
<tr><td>Return on assets (EBIT/RAB or EBIT/ Assets)</td><td>Of the four measures the AER proposed, EBIT/RAB is least affected by the need for assumptions to turn corporate-level financial accounts into asset-level accounts. This is because it is calculated prior to tax or interest; two of the variables likely to require the most significant assumptions. The AER has recognised this, and we concur with the AER in this respect. Two examples from our businesses highlight the issue:
Victoria Power Networks is a holding company for a number of operating legal entities, including CitiPower and Powercor. Debt financing for all these entities is raised at the VPN level with subsidiaries holding little or no debt. Similarly, corporate tax liability is calculated at the consolidated VPN level.
SA Power Networks also finances debt at a consolidated level, and this debt is not apportioned across the group. Further, SA Power Networks is a partnership, and is not a tax paying entity. Tax is incurred at the partner company level.
We also support the AER's proposed approach to calculate EBIT-based measures using regulatory accounts (rather than statutory accounts). The use of regulatory accounts will better ensure consistency across all regulated networks—for example:
the depreciation schedule required in the PTRM may differ from depreciation in the statutory accounts
expenditure, such as superannuation and self-insurance costs, may be accrued for statutory purposes (consistent with standard accounting requirements), but reported on a cash basis for regulatory accounts (consistent with regulatory allowances)
using statutory accounts would require assumptions to apportion items such as cash and intangibles across different assets, and these assumptions would be difficult to standardize
some items are treated differently in regulatory and statutory accounts (e.g. some items treated as operating expenditure in regulatory accounts are treated as capital expenditure in statutory accounts)
Although the EBIT/RAB measure is the most appropriate of those considered by the AER, there may be a simpler measure. For businesses operating under a revenue cap, any differences in EBIT-based outputs (i.e. relative to the regulatory allowance) simply reflect outperformance driven by opex and/or against the service target performance incentive scheme.

Given the AER already collects opex and reliability data through its regulatory information notices, there appears to be limited utility in deriving additional measures of profitability.

A benchmark version of any EBIT-based metric, published as part of the AER's PTRM, would also facilitate like-for-like comparisons.</td></tr>
<tr><td>Return on Equity (NPAT/total equity)</td><td>We perceive three issues specific to this measure that do not appear to have been included in the report published by McGrathNicol:
As the McGrathNicol report acknowledges, measures that use individual businesses interest and tax are distorted by ownership structures, financing and tax arrangements. If the return on equity measure (which uses NPAT) is used, it should use a benchmark measure of interest and tax. Additionally, the accounting equity will not be comparable</td></tr>
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	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. Factors including accounting mark-to-market adjustments and corporate dividend distribution policies may result in significantly different outcomes in the statutory reports from the regulatory benchmark entity, that have no implications for evaluation of the performance of a regulated business. • It is not clear what the total equity denominator ought to be, as the assets are not traded. Simply setting the value at 40 percent of the RAB is an assumption, not a measure of the value of equity, and using the book value of the equity is likely to produce gross distortions if the book value has not been marked to market recently.
Operating profit per customer / connection	We consider McGrathNicol's assessment of this measure to be overly optimistic. In particular, this measure is unlikely to provide sensible comparisons between businesses even within the energy sector. For example, consider Australian Gas Infrastructure Group and two of its assets; the Dampier to Bunbury Natural Gas Pipeline and the AGN Victorian Distribution Network. The DBNGP has a few dozen customers and about 50 connection points. The Victorian Distribution Network, by contrast has more than 600,000 connections and a similar number of customers. Any measure of profitability per connection point between these two businesses is likely to be meaningless. There is also considerable variability between businesses of the same type, such as electricity distribution networks in metropolitan or rural areas (e.g. where lines are much longer). McGrathNicol comment that this measure could provide a good analysis of a business' profitability from year to year. However, it is unclear how this comparison will be any more meaningful than simply comparing trends 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.
Economic profit (EBIT – pre-tax WACC x (total assets (or RAB)); or EBIT – pre-tax WACC x (total assets (or RAB) – current liabilities)	As noted by McGrathNicol, this measure is not a ratio and thus will produce different answers based purely on size. Additionally, 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.

2. Do you agree the five assessment criteria used by McGrathNicol to assess the profitability measures are appropriate? If not, what alternative criteria should be used?

The assessment criteria proposed by McGrathNicol appear reasonable. However, as set out in the body of our submission, the key consideration is the intended use of profitability measures in an incentive framework. Any assessment of specific measures against these criteria, must consider the intended use.

3. Do you agree that the identified data is required to develop the preferred profitability measures?

For the reasons outlined previously, we consider data would preferably only be 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.

For businesses subject to a revenue cap, we also note that existing opex and STPIS data collected through the AER's RIN processes should suffice to derive EBIT-based profitability measures.

4. If you consider other profitability measures should be reported, what data is required to support those measures?

We do not propose additional measures.

5. Do you consider we should use the same measures and data for all regulated businesses, or should we adopt different measures for different sectors (electricity / gas) or different segments (distribution / transmission) of the energy sector?

As a general principle, we prefer consistent measures (across both energy and other sectors). The AER should only consider measures that are capable of widespread application, to avoid a lack of comparability or situations where the only comparison is between actual outcomes and the PTRM. Reporting against a single measure will also assist stakeholders to understand the results, including how they compare across businesses.

6. In addition to profitability measures, should we report other measures of financial performance? If so, how would these other measures contribute to the achievement of the NEO or NGO?

We do not propose additional measures.