

# **Response to the AER's Discussion Paper on Profitability measures for regulated gas and electricity network business**

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## Contents

1	Overview	3
2	Guiding principles for profitability measure development	3
3	Clarifying the purpose of measures	5
4	A 'benchmark' measures approach	6
5	Answers to the Discussion Paper questions	7

# 1 Overview

Energy Networks Australia welcomes the opportunity to provide the industry response to the Australian Energy Regulator's (AER) Discussion Paper on Profitability measures for regulated gas and electricity network businesses.

The Australian energy network businesses look forward to working constructively with the AER and other stakeholders to investigate the advantages and disadvantages of alternative profitability measures with a view to identifying a set of appropriate profitability measures for the AER to collect and report. The energy network businesses also look forward to engagement on the purpose and use of each profitability measure which will form the next critical step in this process.

Energy Networks Australia considers the three key issues below should be the focus for stakeholder engagement as part of the development and use of profitability measures:

- » principles to guide the development of profitability measures;
- » defining the proposed purpose of the measures and clarifying how the measures are envisaged to be used in AER decision-making or as an informational analytical tool; and
- » approaches to ensuring appropriate 'like for like' comparisons are promoted.

Energy Networks Australia also proposes stakeholder input be sought on a potential option of measurement and reporting of profitability drawing on the AER's existing published Post-Tax Revenue Model (PTRM) outputs for each regulatory determination. This model is briefly described in Section 4.

## 2 Guiding principles for profitability measure development

Energy Networks Australia suggests that a set of principles be established to guide development and use of profitability metrics and makes the following initial suggestion of principles:

- » Profitability-related measures collected should be commonly-accepted, uncontroversial measures and careful, appropriate and consistent interpretation of the results should be provided.
- » Due regard must be given to the impact of the existing regulatory arrangements on the measurement of profitability:
  - *The incentive regulation framework.* The objective of incentive regulation is for regulated businesses to seek to improve efficiency to outperform

regulatory benchmarks, so that efficiency improvements can flow through to revised benchmarks. High levels of profitability, measured on an *ex post* basis, may simply indicate that the regulatory framework is working effectively because regulated businesses are responding to efficiency and service quality incentives.

- *The concept of the benchmark efficient entity.* The regulatory allowance is set on the basis of a benchmark efficient entity, whereas each network business is free to depart from the regulatory benchmark. For example, a firm is free to take on more risk than the regulatory benchmark in its financing structure, bearing more risk accordingly. This may result in higher profitability in some years and lower profitability in others (commensurate with the increased risk). Thus, the fact that a particular business demonstrates higher or lower profitability in a particular year may simply result from that business choosing to depart from the regulatory benchmark assumptions.
  - *Cost allocations.* Any profitability metrics developed should relate to the regulated business only. Most regulated businesses also have investments in unregulated assets and some businesses have a portfolio of many assets, some regulated and some unregulated. Cost allocations may be required for some businesses. For example, the financing of regulated and unregulated assets may involve a common debt pool that is transacted by a single corporate treasury. The relevant costs would have to be allocated on some basis between assets.
  - *Features of the regulatory regime.* Ex post profitability in any year can be affected by various elements of the AER's regulatory process, such as smoothing of revenues via the PTRM and regulatory pass-throughs.
- » Limitations that exist specific to a given measure should be appropriately recognised to aid comparisons:
- There are problems with several of the proposed profitability measures (set out in more detail below). As a general principle, the further below the level at which interest and tax are deducted, the more the measures must rely upon arbitrary assumptions about cost and revenue allocation from corporate accounts to the regulated asset level, and the less reflective they are of the actual returns to the relevant stakeholders.
  - Even if one could reliably capture actual returns to equity holders at the asset level, it is unclear how useful the information would be to stakeholders, because the AER's current practice is to exclude direct evidence about actual returns when forming expectations (the AER instead makes an adjustment to the CAPM, and has in the past not accepted business calls for making more direct use of evidence of systematic bias from actual returns). Thus it would not appear to be logically consistent to then compare actual returns to expected returns, when the latter have been formed knowing of, but neglecting, the systematic bias the latter has with respect of the former.
- » Any comparisons must be made on a like-with-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. For example:

- Regulatory depreciation is different from accounting depreciation.
- Regulatory treatment of tax is much simpler than in reality.

Further, if regulated businesses are required to collate and report various profitability measures, the process should be one whereby the AER sets out the precise definition of each metric so that each business can put in place the necessary arrangements to collect the required data from the commencement of its next regulatory control period.

### 3 Clarifying the purpose of measures

The AER's Discussion Paper identifies a set of preferred profitability measures and asks stakeholders to indicate whether they agree with that set of measures. However, the Discussion Paper does not indicate how the AER intends to use the various metrics on which it has proposed to focus. This makes it difficult for stakeholders to form a view about the appropriateness of the proposed metrics.

The Discussion Paper does indicate that the profitability measures may be used for the purpose of comparing the AER's allowance in a regulatory determination with actual outcomes and for comparisons between regulated businesses and with comparable unregulated businesses. However, it is not clear whether the profitability measures are simply to be reported for the information of stakeholders, or whether the AER intends that the comparisons would have a role within the regulatory process, forming the basis for some sort of adjustment to allowed revenues, and if so, how that process might work.

A full understanding of the purpose is important for stakeholders to be able to comment meaningfully on the appropriateness of the various metrics. This is because a particular profitability metric may be appropriate for one purpose, but unsuitable for another.

In the context of profitability measures, an example would be the return on assets metric. 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 assets metric 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.

Energy Networks Australia considers that it is essential in any consideration of profitability metrics must be a clear articulation of:

- » How the particular profitability metric would be used by the AER - proponents of any specific metric would need to indicate how they intend the AER should use that information. It is difficult for other stakeholders to comment on whether a particular profitability metric is fit for purpose, when the purpose is unclear.

- » How the proposed use of each profitability metric would support the National Electricity Objective, National Gas Objective and the Allowed Rate of Return Objective (ARORO).

This information would assist stakeholders in determining whether each proposed profitability metric is appropriate and fit for the intended purpose.

## 4 A ‘benchmark’ measures approach

Energy Networks Australia considers that the use of any profitability metrics should involve a proper like-with-like comparison, as follows:

- » In each determination, the AER would set out benchmark profitability metrics in accordance with its regulatory allowance for the particular network business. This information could be extracted from the Post Tax Revenue Model, and the precise basis for the calculation of these metrics would be set out clearly in advance.
- » Each network business would then report actual outturn metrics on the same basis (e.g., EBIT would be based on regulatory depreciation to ensure a like-with-like comparison).

This approach would provide an appropriate like-with-like comparison, improve transparency and assist stakeholders in understanding how to interpret outturn measures of profitability.

Further, 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. We agree with the AER that 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. We would welcome the opportunity to engage with the AER and other stakeholders on this issue.

## 5 Answers to the Discussion Paper questions

**AER Question 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?

Energy Networks Australia considers that this question is difficult to answer without first knowing the purpose of the exercise and the proposed use of the information. However, at a high level it appears that:

- » For the purpose of comparing the AER's allowance in a regulatory determination with actual outcomes, the key requirement is simply that both quantities are measured in the same way.
- » For the purpose of comparisons with other regulated businesses, or with unregulated businesses, there are material problems with some of the proposed profitability measures. For example:
  - Operating profit per customer is subject to comparability issues and would not provide meaningful insights. For example, profit per customer will be materially different for a gas pipeline with a small number of industrial customer than for an electricity distribution network with millions of small customers.
  - Similarly, it would also seem to be meaningless to compare profit per customer of an energy network business with profit per customer for a toll road or an airline. Although other infrastructure businesses are likely to be in the same risk class with a similar return on capital (in market value terms), the size and value of the service they provide to each of their customers is different from that provided by energy networks, so it is not clear what could be made of any such comparisons.
  - Even if comparisons were restricted to, for example, just electricity distribution networks, there are material problems. For example, consider a comparison between a network that services a densely populated urban area with one that services a sparse rural area.
  - In summary, material adjustments would have to be made to ensure comparability between businesses. If such adjustments cannot be made, then at a minimum it would be necessary for the AER to set out the factors that it was unable to adjust for so that these factors can be taken into account in a qualitative way when comparing profitability measures across businesses. Energy Networks Australia welcomes the opportunity to engage with the AER and other stakeholders on the nature of the adjustments that would have to be made to ensure that valid comparisons are made.
  - **Economic profit** is a dollar measure and so would not provide meaningful comparisons between firms of different size.

- **NPAT/Total equity** is not comparable to the allowed return on equity and so should not be used to make such a comparison. In particular:
  - » The allowed return on equity is based on the market value of equity (commensurate with the standard commercial approach to WACC) and includes the assumed value of imputation credits.
  - » The allowed return on equity is an estimate of the expected average return that investors would require, whereas NPAT represents a single ex post outcome.
  - » Profitability measures based on NPAT are most susceptible to disaggregation issues arising from common costs having to be allocated across assets.

Of the proposed metrics, **EBIT/RAB** is least subject to disaggregation issues and is likely to require the least adjustments to ensure comparability between different network businesses and with businesses in the wider economy.

**AER Question 2:** Do you agree the five assessment criteria used by McGrath Nicol to assess whether the profitability measures are appropriate? If not, what alternative criteria should be used?

Noting that whether the criteria are appropriate will depend on the use that is to be made of the comparison, Energy Networks Australia considers that the criteria set out in the Discussion Paper appear to be largely appropriate.

The specified criteria do seem to be designed to ensure that, to the extent possible, the profitability measures will be constructed in a way that permits a like-with-like comparison to be made.

Having settled on a set of criteria, the various profitability measures must then be assessed against those criteria. Energy Networks Australia considers that step to be complex and difficult in two respects:

- » **It is difficult to determine whether some of the criteria have been satisfied.** For example, it is not at all clear how one would determine whether a particular profitability measure was generally accepted and easily understood by those without a financial background. It is likely that this criteria could be interpreted very differently by different stakeholders. Thus, for the high-level criteria to be of any real use, they would need to be accompanied by an explanation of precisely how different measures would be assessed against those criteria.
- » **Some of the criteria appear to be impossible to satisfy.** For example:
  - All of the proposed profitability measures would appear to require some manipulation of data and assumptions.
  - The proposed operating profit per customer measure would never satisfy the criteria of being appropriate for comparisons across businesses. (Problems with the use of this measure are set out in more detail above.)



Moreover, the relative importance of the various criteria would depend on the (as yet unknown) use that is to be made of the profitability measures. For example:

- » If the measures are to be reported for the general information of stakeholders, it would be important to have measures that are easily understood.
- » If the measures are to be used to adjust allowed revenues and prices, it would be crucial that the measure is appropriate for cross-business comparisons.

**AER Question 3:** Do you agree that the identified data is required to develop the preferred profitability measures?

Energy Networks Australia notes that the data items set out in the Discussion Paper are technically the correct data items required for the construction of the proposed profitability measures.

However, as noted above, it will be a technically complex task to allocate some items that are collected at a firm level to a particular regulated asset. For example, costs incurred by any corporate function (e.g., head office costs, corporate treasury costs) would need to be allocated between the regulated asset in question and any other corporate activities including any other assets or investments.

Energy Networks Australia also notes that a number of the data items set out in the Discussion Paper are already collected as part of the regulatory process, but these items may require some adjustment to be used in the construction of the proposed profitability measures.

Whereas the data items set out in the Discussion Paper are the items that are required to compute the proposed profitability measures, compiling those data items is likely to require allocations and adjustments. If the profitability metrics are to be used to make comparisons across businesses, it is important that any such allocations and adjustments be made in a consistent manner. Consequently, the AER would need to specify not just the data items to be collected, but the precise definition of each, including how any allocations or adjustments would be made.

Finally, data collection should be limited to the data required to construct measures that are meaningful and fit-for-purpose, in order to minimise undue regulatory burden. For example, given the concerns about NPAT-based measures, the benefits of collecting these data (where it is currently not reported) are unclear.

**AER Question 4:** If you consider other profitability measures should be reported, what data is required to support those measures?

Energy Networks Australia notes that the AER has selected a set of profitability metrics based on recommendations from McGrath Nicol.

McGrath Nicol considered 14 potential profitability metrics against a set of criteria and made one primary recommendation and identified three other metrics that the AER considers “may also be appropriate.” A number of problems were identified with the other potential metrics, which were not considered to meet the criteria that had been developed.

Energy Networks Australia agrees that there are issues with the potential metrics that have already been rejected and agrees that the set of metrics to be considered throughout this process should be limited to those that have already been identified by the AER.

**AER Question 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?

Energy Networks Australia submits that this is another question that is difficult to answer without first knowing the purpose of the exercise or the proposed use of the information. Whether or not consistency of measures is required depends on the purpose of the collection of those measures. Therefore, Energy Networks Australia would welcome the opportunity to engage with the AER and other stakeholders to:

- » Determine a set of metrics that can be consistently calculated for the set of businesses to be compared.
- » Identify any adjustments or standardisations that would have to be made to ensure that the measures are made properly comparable on a like-with-like basis.
- » Identify any issues that make cross-business comparisons difficult or inappropriate for a particular measure, such that less weight should be afforded to that measure.

**AER Question 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?

Energy Networks Australia submits that financeability metrics (i.e., those metrics used by rating agencies to assess the creditworthiness of businesses) should be considered as part of the AER's process for setting the allowed return on capital. Hence, no additional metrics are proposed for consideration under the AER's Profitability Measures process.