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AER Profitability Reporting Guideline – allocation of tax and interest expenses

Dear Warwick

APA welcomes the opportunity to comment on the PricewaterhouseCoopers advice regarding the allocation of tax and interest expense in the context of the AER's Profitability Reporting Guideline.

You will recall APA's concerns, expressed in previous submissions on this matter, that any measurement of profitability must be conducted in the context of the regulatory framework in which we are attempting to assess profitability – in particular, that application of statutory accounting measures to a regulatory reporting framework (and vice versa) can only lead to spurious and meaningless results.

APA is therefore concerned, as a starting point, with the apparent insistence in the AER Discussion Paper, that “[w]hile we acknowledge that these allocations are complex in view of differing corporate structures, we are of the view that it can be done.” In APA's view, it is not possible to *allocate* tax and interest to particular assets in a corporate group in any but an arbitrary and meaningless way.

Interest expense

In the context of interest expense, APA submits that any *allocation* of interest expense across a corporate group, in any of the ways discussed by PwC, inherently assumes that all the businesses in the corporate portfolio are financed in the same way – that is, that they all have the same inherent risks, which would drive the same gearing structure and composite cost of debt as the overall corporate portfolio, notwithstanding the diversification benefits associated with the portfolio of assets.

This inherent assumption is not reasonable where the purpose is to determine the amount of interest expense attributable to a single business within the portfolio. Invariably, some businesses will be higher (lower) risk, requiring a higher (lower) level of equity to feature in the capital structure, and would attract higher (lower) financing costs.

The PwC report inadequately addresses the question of how the debt portfolio might be allocated amongst the various regulated and non-regulated assets within the portfolio, where those assets use different asset valuation methodologies. As APA has consistently maintained, any measure that mixes regulatory and statutory measures will deliver spurious and meaningless results.

In this case, any allocation of the debt portfolio that blends regulatory and statutory asset values (for example between a regulated gas pipeline and an unregulated wind farm) will invariably allocate a meaningless proportion of the composite debt portfolio to both assets. Moreover, the interest expense allocated to the regulated business through such a process will be meaningless in the context of the

regulatory framework in which the regulated business' prices have been determined and in which the business' profitability is to be assessed.

While it may be possible to address this through a more complex process as discussed in the PwC paper, APA considers that it would be nigh impossible to justify, to the AER's satisfaction, the extent to which a particular business within the portfolio should be considered to be financed with a different capital structure and with a cost of debt different from the portfolio's composite cost of debt.

APA considers that the AER has, in the context of the binding Rate of Return Instrument, invested an extensive amount of research and analysis in determining the appropriate cost of debt and gearing levels for the businesses whose profitability is to be reported under this Guideline. APA submits that the AER should draw upon this considerable effort in preference to an arbitrary allocation methodology that will, prima facie, be incorrect.

APA therefore recommends that interest expense be directly estimated by calculation, rather than through an arbitrary, and invariably incorrect, allocation methodology. Such a calculation would follow the regulatory process whose performance we are attempting to assess – that is, $RAB \times 60\%$ gearing ratio \times AER-determined cost of debt.

Tax expense

On the subject of tax expense, APA supports PwC's recommendation that it is not necessary to develop an allocation methodology for tax when a direct calculation approach will produce more relevant results. That is, APA supports the approach outlined in Figure 2 of the PwC report.

APA considers that tax depreciation should be drawn directly from the PTRM. APA notes that the regulatory Tax Asset Base (TAB) is not subject to indexation, so an adjustment to remove the effects of inflation would not be required. This would address PwC's concerns on the need to adjust the "book" depreciation for the indexation of the RAB (p15).

APA accepts that tax depreciation under the PTRM has historically applied a straight line, rather than declining balance, approach. There may be a lack of precision in the tax calculation as a result. However, to the extent the tax depreciation is driven more by aged assets than current capital expenditure, the straight line approach will deliver a higher amount of current tax depreciation, and hence a lower tax expense amount and higher reported profitability, than a more precise historical recalculation of available tax depreciation.

There may need to be some adjustment to recognise the indexation component if the calculation methodology starts with EBIT and features an add-back of "book" (in this case, "regulatory") depreciation. APA looks forward to engaging with the AER on this topic.

We would be pleased to discuss this submission with you at your convenience. Please contact [REDACTED] in the first instance.

Yours truly

[REDACTED]

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