Submission to the AER

Discussion Paper: Profitability Measures (Review of PwC Advice)

22/08/2019

APGA Submission to the AER Discussion Paper – Profitability Measures (Review of PwC Advice)

Introduction

The Australian Pipelines and Gas Association (APGA) welcomes the opportunity to comment on the Australian Energy Regulator's (AER) Discussion Paper on the advice received from PWC during the Profitability Measures Review.

APGA is the peak body representing Australasia's pipeline infrastructure, with a focus on gas transmission. Our members include owners, operators, constructors, advisers, engineering companies and suppliers of pipeline products and services. APGA's members build, own and operate the gas transmission infrastructure connecting the disparate gas supply basins and demand centres of Australia, offering a wide range of services to gas producers, retailers and users. The replacement value of Australia's gas transmission infrastructure is estimated to be $50 billion.

A stable and internally consistent regulatory framework is vital to maintaining the attractiveness of the Australian energy sector as a destination for investment. APGA considers that an ability to capture performance against regulatory determinations could play a role in maintaining the attractiveness of the Australian energy sector as a destination for investment by providing confidence that levels of out or under-performance against regulatory benchmarks remain within reasonable bounds given the incentive regulation framework. However, in order to perform this role, the measures need to be clear, meaningful and relevant to the regulatory task.

APGA appreciates that the AER discussion paper focuses on finding the appropriate way to move from the EBIT measures the AER is already using to an NPAT measure. However, we urge the AER to keep in mind the broader purpose of the profitability metrics and ensure that the resultant metrics allow an apples-with-apples comparison with the allowed rate of return.

To take an example, assume a business is borrowing at the ten-year tenor at exactly the rate allowed by the AER but, due to the fact that no actual business is as simple as the benchmark efficient entity, it has some shorter-term debt. The net result will be that its actual cost of debt, however allocated, will be lower than the benchmark. This will mean, in turn, that the NPAT measure will show a higher level of profitability than the allowed return on equity. However, the equity holders are not really earning an "excess" profit in this instance, but are rather facing a different set of risks with, accordingly, a different reward. There is therefore an apples-with-oranges comparison at play which needs to be addressed through considering the metric more carefully.

Allocation of interest expense

With regard to the allocation of interest expense, there are two key issues to consider when reviewing the options suggested by PWC.

First, in its Rate of Return Guideline, the AER argues (*Explanatory Statement, p.47*) that unregulated businesses are riskier than regulated businesses – and uses an APGA member company (APA Group) as an example of this when discussing its beta results (*Explanatory Statement, p.189*). To the extent that this is true, and to the extent that APGA members have both covered and uncovered businesses (with some of the latter being outside the gas sector), it follows that APGA members who borrow at the corporate level for uncovered businesses and covered businesses together can be expected to face a higher cost of debt than they would face if they operated only covered businesses. This is a direct consequence of the AER's argument that unregulated businesses face additional systematic risks compared to regulated businesses.

If the AER is correct, its logic implies that the starting point of the actual cost of debt is likely to be too high compared with that which would prevail if a business was borrow solely to fund regulated assets, and therefore the resultant profit measure will be too low. This is the case regardless of how the actual interest costs are subsequently allocated.

Second, there is an issue around the allocation of interest costs by RAB / statutory asset bases that PWC did not consider. In cases where APGA members have uncovered gas transmission businesses, these usually come under Part 23 of the National Gas Rules which requires – for at least some of these pipelines – the publication of an asset value formed via the "recovered capital method" (RCM). The RCM is formed on a completely different basis to the RAB, with a fundamentally different underpinning, despite being part of the same Rules. Were NPAT measures to mix up RAB and RCM values for covered and uncovered assets, respectively, this would lead to NPAT results affected by differences in the way in which the RCM and RAB operate and not reflective of the actual profitability of the regulated business.

The asset valuation issue also points to a broader issue in respect to the often very different bases of asset valuation between the regulatory and statutory worlds. Different rates of depreciation (indeed an entirely different formulation of depreciation) which are not considered within the regulatory sphere will likely muddy results if the AER attempts to "mix its drinks" by allocating interest on the basis of the RAB of a regulated asset and the statutory value of an unregulated asset.

APGA proposes a fourth option that could be used by businesses and has not been considered by PWC, and that is to use the allowed return on debt as the rate, and 60 percent of the RAB. The allowed return on debt is, in light of the differences the AER perceives between risks of regulated and unregulated businesses and different bases of asset valuation for covered and uncovered assets, the best indication of an appropriate cost of debt for a regulated business in circumstances where an actual business has significant uncovered assets. It is also, as the AER's research in the Rate of Return Guideline shows, not very different from the rate that the energy sector as a whole pays for debt, particularly now that the new Rate of Return Guideline is in force.[1]

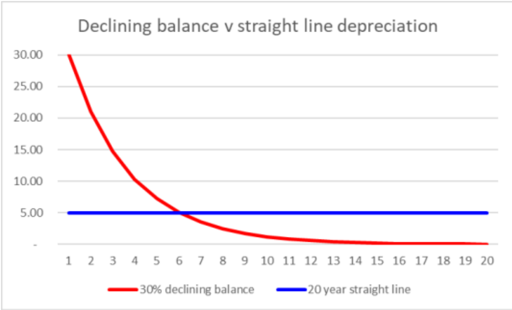
APGA is not suggesting that the proposed fourth option will be appropriate for all businesses. As discussed below, we think it is imperative that businesses have a degree of choice in which method they select. However, this option should be available for businesses which have a sufficiently large portion of their activities in the unregulated sphere.

Allocation of tax expense

APGA considers that PWC's recommended approach, preferring a streamlined tax calculation over what would inevitably be a complex set of allocation rules, is the most appropriate. While acknowledging some minor reduction in accuracy, APGA considers that a more complex allocation methodology would result in a false sense of precision.

[1] *We note also that the average credit rating of gas pipeline debt in the AER's sample in the guideline documents (Explanatory Statement pp284-5) was lower than the BBB+ benchmark and thus the actual cost of debt for gas pipelines is likely higher than for the energy sector as a whole.*

For example, as outlined in the AER tax review, the current year PTRM tax depreciation is likely to differ from the actual tax depreciation, due to the PTRM historically applying straight line tax depreciation. To the extent that the bulk of the regulatory TAB is made up of aged assets rather than current year capex, the actual available declining balance tax depreciation may be lower than the PTRM straight line tax depreciation.



APGA acknowledges that using the higher PTRM tax depreciation amount would result in a lower calculated amount for tax payable and thus higher reported profitability. However, unravelling history to calculate the "correct" amount of tax depreciation that might be applicable to the stand-alone reporting entity would be a monumental task – the increased false sense of precision is not outweighed by the marginally lower accuracy.

In summary, APGA's main concern in respect of the allocation of tax expense is simplicity; to the extent that this becomes a highly convoluted exercise the resultant information will be of little value to stakeholders. To this end, we think that the basic approach outlined by PWC, without any of the complications associated with attempting to allocate tax expense across regulated and unregulated assets, is most appropriate. Therefore:

- Start with the regulatory EBIT
- Deduct interest expense as calculated above
- Add back "book" depreciation (including indexation component) as per the PTRM
- Deduct tax depreciation as per the PTRM
- Add/subtract any other permanent differences
- Derive the taxable income
- Multiply by 30% tax rate
- Derive the tax expense.

The only complication APGA sees in this approach, in a general sense, is the adding back of depreciation. As PWC notes, this will need to include the indexation component which is in the RAB, and the AER is not clear on how this might be done. It appears from the PWC paper that this is to be a work in progress, and APGA would welcome the opportunity to be part of that process.

Responses to questions

1. **Do you agree with the key principles identified by PWC for the allocation of interest and tax expense to the regulated entity?**

APGA continues to hold the view that we must assess outturn profitability within the context of the regulatory framework in which prices have been determined with an aim to delivering a regulator-determined level of profitability. In particular, it is meaningless (and misleading) to compare forecast profitability determined on indexed regulatory asset values against outturn profitability over historical cost statutory asset values. The key principles underlying any allocation methodology must respect the regulatory framework whose effectiveness the reporting seeks to assess.

2. **Do you agree with PWC's recommended approach for allocating tax expenses for corporate structures?**

As noted above, APGA agrees that PWC's proposed approach, applying a streamlined tax calculation, is far preferable to attempting to allocate tax expense among businesses within a corporate group. While accepting a minor reduction in accuracy, APGA considers that the false sense of precision is not outweighed by the enormous task of attempting to calculate the "correct" amount of tax depreciation for the reporting entity.

3. **Do you agree with PwC's recommended approach for allocating tax expenses to flowthrough tax structures?**

No comment.

4. **In light of the advantages and disadvantages that PWC sets out for its three interest allocation approaches, which of these allocations should be used, and why?**

APGA believes that businesses should be offered a choice between the methods, and be required to elaborate why the particular choice is most appropriate for their circumstances. As noted above, this choice should also extend to using APGA's proposed fourth approach, under circumstances which we accept may need to be restricted, such as the portion of revenue earned from unregulated sources.

5. **Are there any further allocation approaches we should consider for tax and/or interest expenses? If so, please identify why you consider these approach/es preferable to those identified in the advice.**

No comment.