carbon + energy markets

PO Box 875
Camberwell South
3124
Victoria

Mobile: 0405 505 060
bruce.mountain@cmeaustralia.com.au

9 November 2017

Australian Energy Regulator
GPO Box 520
Melbourne
3001

by email: aerinquiry@aer.gov.au

Dear Sir/Madam

I am writing to you in response to your invitation to respond to your discussion paper on network service provider profitability measures.

That paper suggests reporting Earnings Before Interest and Tax (EBIT) as a measure of the profitability of network service providers (NSPs).

It is not entirely clear to me what the AER is intending to achieve through this reporting. If the AER's intention is to provide useful insight into the actual profitability of NSPs then EBIT is not a useful measure.

Actual EBIT is calculated as the actual revenue recovered less actual operating expenditure and actual depreciation (by which I presume the AER refers to actual *regulatory* depreciation not the depreciation and amortisation amount in statutpry accounts). EBIT divided by the Regulated Asset Base (RAB) will equal the pre-tax WACC as long as revenue recovered, capex and opex are the same as the AER determined in its revenue control decision.

Hence all that "actual" EBIT/RAB (relative to "allowed" EBIT/RAB i.e. pre-tax WACC) will tell you is the actual relative to allowed profitability of :

- the variance in revenue recovery from the amount allowed (which is trued-up in later years anyway),
- differences in opex from amounts allowed (which does not matter greatly anyway since opex is not a major part of allowed revenue) and
- variances in capex from amounts allowed but expressed a differences in allowed and actual regulatory depreciation.

Since the variance in revenue recovery is trued-up we can ignore that. Hence the only information we get from tracking EBIT as you propose  is opex and depreciation variances.

Such information is far more usefully expressed simply as the difference in allowed and actual capex and opex, which is already tracked in the Regulatory Information Notices. The AER is not adding anything through the proposed EBIT measure, and as a measure of NSPs' actual profitability the proposed EBIT measure provides no meaningful additional imsight.

If the AER does indeed wish to monitor network service providers' actual profitability, I suggest more useful measures here.

The main measure that I suggest the AER should report is Return on Capital Employed. This is the net profit after tax divided by actual shareholder equity (not the AER's assumed 40%).

For the government owned NSPs (or in the case of the partially privatised New South Wales NSPs) it is important to add back income tax equivalent payments and debt guarantee/competitive neutrality fees in the expression of this measure for government owners (tax and debt guarantee fees constitute part of the owning governments' financial return).

In addition, in respect of shareholder equity, it will be valuable to distinguish equity created through asset revaluations (including CPI indexation of the RAB) as distinct from equity that was created through subscription and equity sourced from retained profits.

Furthermore for the government-owned distributors, since debt is provided by the government itself, this is a related party loan and it would be helpful to disclose the actual interest rates on those loans relative to the AER's determination of the return on debt. This is also true for some of the privately owned distributors some of whose debt has been provided through related party loans at premium interest rates. Such premia are simply a form of rent extraction like an after-tax profit and it would be helpful for the AER to monitor and publish this.

Finally, it would be helpful for the AER to publish information on dividends and shareholder loans. Such actual cash transfer data  will be helpful in providing a clear picture of actual network service provider profitability and financial capacity.

I suggest that this reporting extend from 2006 onwards. As far as I can see these measures should be easy to compile using the publicly available information and I commend them for your consideration.

Yours faithfully,

Dr Bruce Mountain
Director