30 May 2018

Mr Warwick Anderson
Director, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
CANBERRA ACT 2601

Dear Mr Anderson

Draft Position Paper: Profitability measures for regulated gas and electricity network businesses

Energex Limited (Energex) and Ergon Energy Corporation Limited (Ergon Energy) appreciate the opportunity to provide a submission to the Australian Energy Regulator (AER) on its *Draft Position Paper: Profitability measures for regulated gas and electricity network businesses* (draft position paper). The draft position paper responds to feedback provided by stakeholders on proposed profitability measures and provides the AER's views on the suite of measures it proposes to report.

Energex and Ergon Energy remain supportive of the AER's intention to report on the profitability of regulated network businesses and agree there would be benefits in enabling comparison of performance information between network service providers and other businesses in the broader economy. However, we also remain concerned that any profitability measures developed and reported by the AER must be fit-for-purpose, commonly accepted and capable of being easily understood and interpreted by all stakeholders. In order to achieve these criteria, we consider that further consideration and consultation on the proposed profitability measures is required. To assist the AER, we have provided our comments relating to specific issues in the attachment submission.

Energex and Ergon Energy would welcome being involved in any further engagement with the AER and other stakeholders in the development of an appropriate profitability measurement framework.

Should you require additional information or wish to discuss any aspect of the attached submission, please do not hesitate to contact either myself on [redacted] or Trudy Fraser on [redacted].

Yours sincerely

[redacted]

Jenny Doyle
General Manager Regulation and Pricing
Telephone: [redacted]
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Profitability measures for regulated gas and electricity network businesses

Joint response to the Australian Energy Regulator's Draft Position Paper

31 May 2018

Part of the Energy Queensland Group

ABOUT ERGON ENERGY

Ergon Energy Corporation Limited (Ergon Energy) is part of the Energy Queensland Group and manages an electricity distribution network which supplies electricity to more than 740,000 customers. Our vast operating area covers over one million square kilometres – around 97% of the state of Queensland – from the expanding coastal and rural population centres to the remote communities of outback Queensland and the Torres Strait.

Our electricity network consists of approximately 160,000 kilometres of powerlines and one million power poles, along with associated infrastructure such as major substations and power transformers.

We also own and operate 33 stand-alone power stations that provide supply to isolated communities across Queensland which are not connected to the main electricity grid.

ABOUT ENERGEX

Energex Limited (Energex) is part of the Energy Queensland Group and manages an electricity distribution network delivering world-class energy products and services to one of Australia's fastest growing communities – the South-East Queensland region.

We have been supplying electricity to Queenslanders for more than 100 years and today provide distribution services to almost 1.4 million domestic and business connections, delivering electricity to a population base of around 3.4 million people via 52,000km of overhead and underground network.

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1 INTRODUCTION

On 27 April 2018, the Australian Energy Regulatory (AER) published the *Profitability measures for regulated gas and electricity network businesses draft position paper* (draft position paper). The draft position paper responds to feedback provided by stakeholders on proposed profitability measures and provides the AER's views on the suite of measures it proposes to report. Energex and Ergon Energy welcome the opportunity to participate in the consultation process and provide comment on the AER's draft position in this submission.

The overall aim of the review is to identify suitable profitability measures that can be reported by the AER to allow stakeholders to compare the returns of regulated service providers. It is intended that publication of this information will facilitate greater transparency and participation by stakeholders in the regulatory process. To achieve this goal the AER has proposed that, rather than relying on a single measure of profitability, a suite of six profitability measures is necessary to allow stakeholders to undertake a comprehensive assessment of service providers' profitability and a broader range of comparisons. This suite of measures is as follows:

- Return on Assets (Regulatory)
- Return on Assets (Statutory)
- Return on Regulatory Equity (Regulatory)
- Return on Equity (Statutory)
- Earnings Before Interest and Tax (EBIT) / Customer numbers (Regulatory)
- Regulatory Asset Base (RAB) multiples

The AER has requested that interested parties make submission on its draft position on profitability measures by 30 May 2018. Comments are provided by Energex and Ergon Energy in Section 2 of this submission.

Energex and Ergon Energy have also contributed to and support Energy Networks Australia's submission on this consultation and are supportive of the views expressed therein.

We are available to discuss this submission or provide further detail regarding the matters raised.

2 COMMENTS ON DRAFT POSITION

Energex and Ergon Energy remain supportive of the AER's intention to report on the profitability of regulated electricity and gas network businesses. We agree that there would be benefits to enabling comparison of performance information between entities to improve the transparency of the AER's regulatory activities and improve stakeholders' participation in the regulatory process.

However, Energex and Ergon Energy also remain concerned that any profitability measures developed and reported by the AER must be fit-for-purpose and meaningful. To achieve the desired outcomes, the suite of profitability measures reported by the AER must accurately reflect the actual profitability of network businesses, allow for meaningful comparisons across businesses and be easily understood and interpreted by all stakeholders without the need for extensive explanation and guidance. Energex and Ergon Energy consider that further work is required to ensure that these outcomes are achieved. Our specific comments are provided below.

1. Risks in using adjusted statutory information for profitability measures

One of the key goals of the profitability reporting framework is to allow a like-for-like comparison of network service providers' profits with other businesses in the broader economy. To address issues associated with comparing the profitability of businesses operating under a regulatory accounting framework with businesses operating under a statutory accounting framework, the AER is proposing the inclusion of additional profitability measures that will require service providers to report information on a statutory accounting basis.

Energex and Ergon Energy (as part of the Energy Queensland Group) continue to have a number of concerns regarding the use of statutory profitability measures (i.e. Return on Assets (Statutory) and Return on Equity (Statutory)) related primarily to a lack of comparability due to differences in ownership structures. It remains unclear as to whether these measures will provide sensible comparisons or suggest differences in performance that are in reality due to structural differences.

Our key issues are as follows:

- ***Allocations from corporate level to the regulated entity***

  Where a company raises capital at a corporate level, McGrathNicol has advised it is possible to allocate interest, tax, total assets and equity from the corporate level to the service provider level.

  Energex and Ergon Energy now form part of the Energy Queensland Group (since 30 June 2016). Energy Queensland is a Queensland Government Owned Corporation that operates a group of businesses, including the two distribution network service providers, a regional service delivery retailer and an affiliated contestable energy services business. As such, Energy Queensland now holds the debt for the consolidated group, and for statutory purposes, interest, tax, total assets and equity for the financing of that debt are recognised by Energy Queensland.

In our view, there are clear risks in presenting information on a statutory basis after adjusting for regulatory-specific amendments for interest, tax, total assets and equity. If the statutory information does not align with the audited statutory accounts, it is not presented on a statutory basis. Any regulatory-specific adjustments should be kept to special-purpose financial statements presented on a regulatory basis, rather than creating a hybrid financial position. Conversely, to exclude financing costs from profitability calculations, albeit against statutory accounting principles to recognise at the service provider level, could give an incorrect inference that the service provider is more profitable than they are in reality. There is no ideal approach to using statutory information to measure profitability.

For comparability of the regulatory income statement, Energex and Ergon Energy are not opposed to reflecting the interest and tax costs for regulated services on a regulatory basis (Return on Equity (Regulatory)). However, although it is intended that guidance will be provided by the AER, it is our view that the service provider would be the best positioned party to devise the most appropriate methodology for apportioning costs amongst the consolidated group. We would therefore welcome the opportunity to provide input into the AER's Regulatory Information Notice (RIN) principles.

Additionally, given Energy Queensland holds a share of the Queensland Government debt, it should be noted that its debt gearing is higher than that of a regulated benchmarked firm. To disseminate the debt into the distribution businesses would reflect higher interest costs than the allowance. This issue would apply more broadly to the general reporting group (gas, distribution and transmission) where the regulated service provider is part of a consolidated group.

- ***The use of statutory accounts for service providers will capture more than core regulated services***

  Energex and Ergon Energy are concerned that for the purposes of reporting profitability measures, the use of statutory accounts for regulated network service providers may inadvertently capture not only information relating to regulated services but also activities performed on an unregulated basis, i.e. if balance sheet and income statement information is to be reported for a legal entity. In this regard, Energex and Ergon Energy are likely to be reporting regulated and unregulated performance to varying degrees over the initial reporting period (i.e. 2015/16 to 2018/19).

  For instance, Ergon Energy, as a distribution network service provider, owns and operates 34 isolated networks and 33 isolated generators (referred to together as isolated systems) that supply isolated communities across Queensland and which are not connected to the main electricity network. Ergon Energy holds a waiver from legal separation under the AER's *Ring-Fencing Guideline*, which currently does not cease until June 2025 (noting there is opportunity to apply for an extension to the waiver).

The primary purpose of reporting profitability information is to provide greater transparency of the network service providers' performance with respect to core regulated services (i.e. standard control services). However, the conflation of reporting core regulated services, alternative control services and unregulated services (which are not under the regulatory oversight of the AER) would merely serve to 'muddy the waters' for profitability results and create 'noise' on those services which are outside the scope of the profitability measures framework.

- ***Variability in statutory asset valuation approaches amongst comparators***

  Many entities in the private sector use the historical cost basis for valuing their supply system. Energex and Ergon Energy are required by their shareholders to value the statutory assets at fair value for inclusion in the State of Queensland's financial statements. As a result, the value of the statutory asset base for the two distribution network service providers is closely aligned to the RAB values. Although not unique, this alignment is uncommon in many other distribution network service providers in Australia.

  Consequently, the variability in asset valuation approaches will compromise comparability of profitability results.

- ***Depreciation***

  There are a number of differences between statutory depreciation based on statutory property, plant and equipment (PPE) and regulatory depreciation in the RAB. In summary:

  - PPE is measured at fair value on the basis of an income approach with revaluation increments recognised in the profit and loss or the revaluation reserve, whereas asset revaluations are not allowed in the RAB. Instead, the RAB is increased by a timing assumption on capital expenditure which applies a half-nominal Weighted Average Cost of Capital and is indexed for inflation;
  - The RAB applies forecast net capital expenditure from year five of the previous regulatory control period to the opening balance whereas PPE does not incorporate forecasts, with all capital expenditure based on actual costs;
  - Timing of recognition differs for capital expenditure accounted for on a commissioned basis in PPE and on an incurred basis in the RAB; and
  - Depreciation is based on actual depreciation on PPE and forecast depreciation on the RAB. Actual depreciation on PPE commences at the point the asset is recognised (commissioned), whereas forecast depreciation commences the year following when net capital expenditure is forecast to be incurred.

Appropriate caveats would therefore need to be documented in the Annual Performance Report to provide an understanding to the user of these differences.

- ***Accounting policy differences***

  There are differences in past accounting policies between Energex and Ergon Energy that will mean comparability between the two distribution network service providers should be undertaken with a degree of caution. This would also be the case across other network service providers. All companies comply with accounting standards but different depreciation methods, work practices and materiality levels may result in differences in treatment of certain items.

- ***ASIC granted relief for Energex and Ergon Energy from reporting financial statements***

  Pursuant to the ASIC Corporations (Wholly-owned Companies) Instrument 2016/785, relief has been granted to Energex and Ergon Energy from the requirements under the *Corporations Act* 2001 for the preparation, audit and lodgement of their financial reports. Subsequently, the operations of the distribution network service provider legal entities now form part of the general purpose financial report for Energy Queensland. Therefore, reporting of any statutory information for Energex and Ergon Energy as standalone entities would require the development of new reports as current income statements and balance sheets are configured for the consolidated group. Additional audit fees would also be incurred.

Energex and Ergon Energy are ultimately of the view that, rather than providing greater transparency, alignment and comparability, the use of statutory measures would result in additional complexity and misleading and unhelpful comparisons. Therefore, we strongly urge that further consideration is given to focusing greater effort on the development of robust regulatory accounts so as to remove the need to use statutory accounting measures.

2. Reporting on profit per customer (EBIT / Customer Numbers)

Another key concern for Energex and Ergon Energy is the proposal to use profit per customer to compare and benchmark network service providers against each other on the basis that it is an easily understood measure and simple to calculate. This measure has been included despite not being supported by service providers.

However, Energex and Ergon Energy remain of the view that the profit per customer measure is not a suitable measure for comparing profitability between businesses for the following reasons:

- Profit per customer does not standardise EBIT so that service providers of different sizes can be compared on similar terms where customer density and industry characteristics differ;

- It is unclear how the AER will have regard to and account for differences in customer density and specific legislative requirements between service providers in analysis of the outturn results of the measure; and
- Stakeholders may erroneously compare operating profit per customer to an average residential customer bill.

Energex and Ergon Energy therefore do not believe that profit per customer can be considered an easily understood measure but rather may result in misinterpretation and misleading comparisons between businesses. Consequently, we do not support the inclusion of this measure.

3. Purposes for which profitability measures are used

There is no clear linkage between the benchmarking of profitability measures for regulated service providers against intended comparators for each measure. Energex and Ergon Energy therefore request increased clarity on the following:

- Which Australian and international regulated businesses where the RAB is valued on a reasonably consistent basis to that of the service provider are considered appropriate by the AER for use as comparators;
- Whether the regulated returns of distribution network service providers will be compared to the transmission network service provider and gas subsectors;
- Which businesses outside of the sector that have similar capital intensity and risk will be selected for use as comparators; and
- Whether it is the AER's intention for the comparator entities to be organic and to change over time depending on the economic environment for the regulatory reporting year.

4. Data collection and reporting

Energex and Ergon Energy also provide the following comments with respect to data collection and reporting for further consideration:

- Currently, the intention is for service providers to report an income statement and balance sheet with some regulatory specific adjustments surrounding the recognition of financing arrangements by the service provider. There is merit in introducing an additional template for the outturn results of the profitability measures and explanations for significant variances against comparators (i.e. historical results) in the RIN. This is demonstrated in the financial sector where authorised deposit-taking institutions report outturn results such as liquidity to the Australian Prudential Regulation Authority.
- It would be beneficial to obtain increased visibility of the AER's intended format (i.e. averages, comparators, etc.) for profitability reporting in its Annual Performance report. The foreseeable workload after profitably results are calculated will shift to explaining what the results mean against the comparator entity and it is currently unclear how the AER will address the context surrounding the results and how those

messages will be managed. Energex and Ergon Energy therefore consider greater visibility of the proposed format would assist in aligning expectations of all stakeholders (particularly during the consultation process).

5. Next steps

Energex and Ergon Energy believe that the issues outlined above require further consideration and consultation. We are of the view that it is worthwhile to allocate the necessary effort to ensuring the proposed measures are fit-for-purpose and meaningful prior to implementation rather than attempting to address issues and unintended consequences post-implementation. We are therefore supportive of:

- Establishing a joint technical working group (as raised during the AER's forum on 16 May 2018) comprised of service providers and other stakeholders (including consumer groups), to develop a consistent approach to reporting profitability measures;
- Delaying the pre-release of profitability results for Return on Assets (Regulatory) to avoid providing misleading results. Any current results are based on existing data which is not consistently applied in RINs by other service providers or by other distribution network service providers over the reporting period (i.e. where there has been an interchangeable presentation of depreciation expense as either statutory depreciation (based on PPE) or regulatory depreciation (based on the RAB); and
- Delaying commencement of profitability measures reporting until 2018/19 following consultation on a Regulatory Information Instrument.

We would welcome being involved in any further engagement with the AER and other stakeholders in the development of an appropriate profitability measurement framework.