8 December 2017

Ms Kaye Johnston
Director, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
CANBERRA ACT 2601

Dear Ms Johnston

Discussion 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 *Discussion Paper: Profitability measures for regulated gas and electricity network businesses* (discussion paper). The discussion paper seeks feedback from stakeholders on proposed profitability measures that could be used by the AER and data required to calculate those measures.

Energex and Ergon Energy are supportive of the AER's intention to report on the profitability of regulated network businesses. As noted by the AER in the discussion paper, consumer groups consistently raise concerns that the building block framework allows regulated network businesses to be over-compensated (and thus earn excessive profits). As these claims are often supported by financial data or measures which do not provide an accurate reflection of the actual profitability of network businesses, Energex and Ergon Energy consider that it is in the best interests of all stakeholders for the AER to develop and report on measures that accurately reflect the profitability of networks. However, 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.

To assist the AER in its development of an appropriate profitability measures framework, Energex and Ergon Energy have provided responses to the specific issues raised in the discussion paper in relation to the preferred measures and associated data requirements in the attached submission. Our submission also discusses additional issues which we believe should also be considered as part of this process, including:

- the range of issues that must be taken into account when comparing profitability across regulated network businesses and other businesses in the broader economy; and

- the need for independent and informed guidance and information to aid stakeholders in interpreting the results.

Energex and Ergon Energy would also 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 (07) 3851 6416 or Trudy Fraser on (07) 3851 6787.

Yours sincerely

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Profitability measures for regulated gas and electricity network business

Joint response to the Australian Energy Regulator's Discussion Paper

8 December 2017

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 8 November 2017, the Australian Energy Regulatory (AER) published the *AER Discussion Paper: Profitability measures for regulated gas and electricity network businesses* (discussion paper). The discussion paper seeks feedback from stakeholders on proposed profitability measures that could be used by the AER and data required to calculate those measures. Energex and Ergon Energy welcome the opportunity to participate in the consultation process and provide comment on the issues raised in the discussion paper in this submission.

In response to concerns raised by consumer groups regarding excessive profitability of regulated electricity and gas businesses, the AER is seeking to collect additional data to measure actual profitability as part of the annual regulatory reporting process. The AER's preferred profitability measures and data requirements have been identified following a scoping study undertaken by McGrathNicol into measures that could be used by the AER to not only measure the actual profitability of regulated entities but also compare the profitability of the regulated entity with other regulated entities and businesses operating in the broader Australian economy. A range of measures were assessed against a number of assessment criteria, including whether the measure:

- is based on clear concepts and able to be calculated consistently over time;
- can be calculated without the need for manipulation of data or assumptions;
- is generally accepted and easily understood;
- is suited to the characteristics of the industry; and
- can be used to compare profitability across the sector and with other businesses.[1]

McGrathNicol's assessment identified four profitability measures that may be appropriate for use by the AER:

- Return on Assets (EBIT);
- Return on Equity;
- Operating profit per customer / connection; and
- Economic profit.[2]

[1] *AER Discussion Paper: Profitability measures for regulated gas and electricity network business*, November 2017, p. 8.

[2] Ibid, p 8.

The AER has requested that interested parties make submission on the preferred profitability measures and associated data requirements by 8 December 2017. Our comments are provided in Sections 2 and 3. We are available to discuss this submission or provide further detail regarding the matters raised.

2 GENERAL COMMENTS

Energex and Ergon Energy are supportive of the AER's intention to report on the profitability of regulated electricity and gas network businesses. As noted by the AER, consumer groups consistently raise concerns that the building block framework allows regulated network businesses to be over-compensated (and thus earn excessive profits).[3] As these claims are often supported by financial data or measures which do not provide an accurate reflection of the actual profitability of network businesses, Energex and Ergon Energy consider that it is in the best interests of all stakeholders for the AER to develop and report on measures that accurately reflect the profitability of networks, and in doing so:

- increase the transparency of the AER's regulatory activities;
- improve stakeholder participation in the regulatory process; and
- assist in the achievement of the National Gas and Electricity Objectives.

However, it is important that any 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.

Developing profitability measures for the energy sector is not straightforward. To be effective in achieving the desired outcomes, the performance measures used by the AER must allow for meaningful comparisons across regulated electricity and gas businesses and other businesses. In determining how the proposed framework's objectives can be achieved, there are a range of issues that will need to be borne in mind, including:

- The results of profitability measures will vary between businesses due to differences in accounting policies (or other factors typically included in notes to financial accounts).
- Most businesses are unlikely to be directly comparable on a financial basis due to differences in the nature of the business, business drivers, risk tolerance, corporate structure and ownership as well as the different stages in business cycles between markets and businesses.
- There are fundamental differences between regulated and unregulated businesses (and / or the split between regulated and unregulated activities). For instance, unregulated businesses are generally exposed to greater year-on-year volatility in

[3] Ibid, p. 2.

profitability, meaning that they may appear less profitable in some years and far more profitable in others.

- In most cases, it will be difficult to separate the regulated entities from group structures without significant manipulation of the underlying data. This is because a variety of corporate structures are seen between the Australian network service providers that allocate group expenses, operational synergies and risk exposure differently between related entities and external contractors and service providers. For the same reasons, broader comparisons to different industries would be even more problematic, without a more detailed understanding of each comparator business.

Consequently, the comparison of profitability will require a level of financial literacy and / or clear qualification and transparent interpretation by the AER when publishing the results to avoid unhelpful or misinformed comparisons influencing regulatory decision-making or dominating regulatory consultations. This risk arises because regulated utilities will generally offer a more stable return over time than other industries. Consequently, regulated (or contracted) infrastructure will typically earn higher relative equity returns during periods of lower market returns (i.e. above average profitability) as a consequence of the lower relative equity returns over periods of higher market returns (i.e. lower than average profitability). In fact, it is this characteristic of infrastructure returns that has led to growing global interest in infrastructure assets as an investment class and facilitated greater private participation and competition in infrastructure ownership.

Therefore, while Energex and Ergon Energy support more transparency and meaningful comparisons between businesses, there will be a need for the AER to provide independent and informed guidance to stakeholders. Such guidance will be particularly vital if the AER is to effectively meet the criteria of having measures in place that are ‘easily understood by those without a financial background’[4] since financial accounting standards assume a level of knowledge to enable reliable interpretation. Specifically, we consider stakeholders will require information that:

- aids their interpretation of the results;
- highlights the limitations of the measures used, particularly when being used for comparison purposes;
- states that an informed analysis will require the interpretation of all available information from a variety of sources (i.e. that the profitability comparisons published

[4] Ibid, p. 8.

by the AER are not definitive and should merely form one part of the stakeholder's assessment process);

- helps facilitate a common understanding of the implications of regulation on profitability; and
- emphasises the benefits that a stable regulatory framework delivers to customers over time.

Energex and Ergon Energy have provided further comments in regard to the specific issues raised in the AER's discussion paper in section 3 of this submission. We would also welcome being involved in any further engagement with the AER and other stakeholders in the development of an appropriate profitability measurement framework.

Energex and Ergon Energy have also contributed to and support Energy Networks Australia's (ENA's) submission on this consultation. In particular, we agree with the ENA's recommendation that further clarity as to the purposes for which the profitability measures are to be used would assist in effectively assessing the appropriateness of the preferred measures identified in the discussion paper.

3 RESPONSES TO SPECIFIC ISSUES RAISED

AER Question	Energex and Ergon Energy Response
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?	Of the four preferred profitability measures identified by McGrathNicol, Energex and Ergon Energy agree that Return on Assets (EBIT) most strongly meets all criteria and is therefore an appropriate profitability measure for regulated network businesses. However, given there are significant difficulties in making equal comparisons between regulated network businesses and even greater challenges in comparing profitability across industries, we have reservations about the use of the other preferred measures as follows: • ***Return on Equity*** is heavily influenced by tax and financing treatments. • ***Operating profit per customer / connection*** cannot be used to compare profitability between businesses due to differences in customer / connection types and requirements which can vary significantly across geographical locations and sectors / segments. • ***Economic profit*** only provides a dollar value of profitability and therefore does not allow for meaningful comparisons between businesses of different sizes. Energex and Ergon Energy therefore consider these additional measures would be of limited benefit to stakeholders without a high degree of qualification and interpretation.

AER Question	Energex and Ergon Energy Response
Question 2 Do you agree the five assessment criteria used by McGrathNicol to assess the profitability measures are appropriate? If not, what alternative criteria should be used?	The five assessment criteria used by McGrathNicol are reasonable. It is important that any measures developed and reported by the AER must be fit-for-purpose (i.e. not subject to significant manipulation or assumptions), commonly accepted, capable of being easily understood and interpreted by all stakeholders and should allow for meaningful comparisons across businesses.
Question 3 Do you agree that the identified data is required to develop the preferred profitability measures?	Energex and Ergon Energy have concerns regarding the appropriateness of the data used in McGrathNicol's scoping study for calculating the preferred profitability measures. Specifically: • The term 'regulated distribution business' is critical terminology that must be clarified by the AER to ensure that correct data is sourced. This term is defined in the Annual Reporting RIN (AR RIN) to include Standard Control Services (SCS), Alternative Control Services (ACS) and Negotiated Services. However, in the context of reporting profitability measures, we believe it is the intent of the AER to report on the profitability of network service providers for SCS only. • Data should categorically be sourced from the annual regulatory performance of the network service provider. To source Regulatory Asset Base (RAB) data from the Post Tax Revenue Model (PTRM) would report on the network service provider's ability to forecast profitability, rather than its actual performance. To source customer numbers from the *State of the Energy Market* report would use outdated customer counts, given the timing of its publication.

AER Question	Energex and Ergon Energy Response
	• In all instances, the SCS column in the Income Statement and Balance Sheet should be used for measuring profitability. It is inconsistent to compare revenue cap and weighted average price cap EBIT to revenue cap assets for Return on Assets (EBIT). • The RAB for Return on Assets (EBIT) is currently reported in the annual Economic Benchmarking RIN at Table 3.3.1 RAB. The introduction of a Balance Sheet is not required for sourcing the RAB closing balance. • The pre-tax Weighted Average Cost of Capital (WACC) should reflect the annual changes in inflation and the trailing average cost of debt. Sourcing the pre-tax WACC from the PTRM would apply a static return for each year of the regulatory control period. For meaningful profitability results to be assessed, assurance requirements assist to drive robust and reliable information. More specifically: • Assurance requirements within RINs allow for financial and non-financial information to be reviewed or audited by a body independent to the network service provider. Energex and Ergon Energy support this approach in striving for the presentation of information which is true and fair. • Data must be robust and reliable (and not contingent on judgements and assumptions for which there are valid alternatives) for confidence in numbers reported. In this

AER Question	Energex and Ergon Energy Response
	context, the following matters should be considered: − A Balance Sheet requires the apportionment of assets and liabilities across services (SCS, ACS and Unregulated). Reliance on assumptions dilutes the reliability of the data and comparability across network service providers for Total Equity and Total Assets. − The current AR RIN requires reporting of a consolidated Excel workbook (Appendix B: Information Templates) which does not differentiate between actual and estimated information. Additional reporting of Actual and Estimated templates would provide transparency for identifying reliable underlying data. − The approach to reporting depreciation in the Income Statement and the RAB values in the Balance Sheet should be clarified. There are inconsistencies across network service providers and / or across initial regulatory years to date. Approaches include recognising statutory values for regulatory assets or regulatory values from economic models. • Caution should be taken where reporting of profitability measures incorporates initial regulatory years for which back cast information is required. The scoping study reviewed data sources for a back cast period of seven years (from 2010/11). Reporting

AER Question	Energex and Ergon Energy Response
	retrospectively will impose additional costs to network service providers given foreseeable issues such as: − The application of terms which are redefined or clarified by the AER to align interpretation of reporting requirements to past reporting which would result in different financial results; and − The introduction of the Balance Sheet is a new reporting requirement and is not currently contained in the AR RIN. As noted by McGrathNicol only three years of historical Balance Sheet information is available (2010/11 – 2012/13) over their review period. • If adjustments are required to data and information post RIN lodgement resulting in subsequent versions of the document being submitted to the AER, consideration should be given to the process for reflecting these changes in profitability measures retrospectively. • Clarification is required as to whether it is the AER's intention for the data (Income Statement, Balance Sheet and customer numbers) to be collected from network service providers for the AER to calculate and report the results of profitability measures. If so, Energex and Ergon Energy would be open to discussing the reporting of results of profitability annually in RINs in addition to the underlying data required.

AER Question	Energex and Ergon Energy Response
	In continuation of the interactive approach adopted by the AER in this consultation, Energex and Ergon Energy note that a formal consultation process will be required for any proposed revision of the RINs (in accordance with clause 28J of the National Electricity Law.
Question 4 If you consider other profitability measures should be reported, what data is required to support those measures?	Energex and Ergon Energy do not believe there are any alternative measures of profitability that would be appropriate for use by the 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?	Where any comparisons between regulated network businesses are made, the same measures should be used consistently to enable the AER and stakeholders to meaningfully assess and compare profitability. Where necessary, any inconsistencies or limitations that exist specific to a regulated entity should be appropriately documented to aid comparisons. For example, measures such as operating profit per customer / connection and economic profit do not lend themselves to comparability and therefore these measures would need to be used and interpreted with care.
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?	Energex and Ergon Energy do not consider any other measures of financial performance are required.