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Ms Kaye Johnston
Director, Network Finance and Reporting
Australian Energy Regulator
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Canberra ACT 2601
Sent by email: aerinquiry@aer.gov.au

Profitability measures for regulated gas and electricity network business

Discussion Paper

Dear Ms Johnston

Major Energy Users Inc (MEU) is pleased for the opportunity to provide its views on the Australian Energy Regulator (AER) Discussion Paper addressing profitability measures to be used as part of the regulation process for electricity and gas networks.

The MEU is pleased that the AER has decided to implement a process for identifying the profitability of energy networks as part of the regulatory process. The MEU considers that the networks are able to acquire a much higher level of profitability than has been recognised and this is an outcome of both the approach set by the rules and by the AER processes. Comparing the profitability of networks to a cohort of other capital intensive firms will better inform the AER as to the approaches it uses in the regulation of networks

Overview

The MEU considers that the profitability measures serve three basic purposes.

Firstly, they assist in identifying if the networks are enjoying higher profits than would be expected when measured against the cohort of all firms where profitability data is available. The MEU does not have an issue with whether the networks achieve high levels of profitability but whether this profitability is excessive when compared to the relative risks faced by them.

The second use of the profitability measures is to identify if the network profits are considered excessive when compared to the relative risks faced by networks and what might be the causes of generating such excessive profits. The MEU sees that part of the value provided by the profitability measures is in the investigation for the causes of

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these excessive profits being generated as the measures should provide some clarity on where the source(s) of such excessive profitability come from.

The third use of the profitability measures is to provide sufficient information to other stakeholders to carry out their investigations and comparisons. While the MEU is aware that the AER has the necessary powers to carry out deeper investigation into the financial details of a network, this ability is not available to stakeholders in general. This means that the AER has the responsibility to ensure that there is sufficient information available to other stakeholders (especially consumers who are paying for the services provided) for them to identify and then provide informed input into AER deliberations. In this regard, the MEU has noted with some pleasure that advocates for consumer have used the extensive information now provided annually through the network performance Regulatory Information Notices (RIN) for benchmarking and category analysis. The issue of network profitability is an extension of this benchmarking activity

All of these three needs are critical as part of the assessment to inform on what the profitability measures might be and how they might be generated.

With this in mind, the MEU considers that it is not just the ease of generating the profitability measure(s) might be but also the value the measure(s) can provide if further investigation is required.

Measures

The MEU strongly supports the AER in its view that advice on profitability measures for networks should be implemented. However, the MEU considers that such measures must be directly comparable to those used widely in financial markets.

Although the profits for a regulated network is embedded in the rate of return applied to the regulated asset base (ie WACC*RAB), the MEU has also noted that the sale value of networks has consistently exceeded the RAB by a considerable margin. The import of this is that the profitability of the firm exceeds that implied by

- The rate of return allowed by the AER
- The size of the RAB to which the rate of return is applied
- The tax treatment applied by the AER
- The process for setting incentives where these might exceed the value to consumers of the services provided.

Measures based on the RAB

The MEU has observed over the years that the setting of the regulatory asset base (RAB) is unique in setting the profitability of regulated firms. Whereas the accounting standards used widely to provide a basis for the various profitability measures is based on a depreciated actual cost basis, the regulatory process bases the asset value on a depreciated replacement cost basis. The outturn of this difference is that:

- Any measure based on the RAB will deliver a measure that is understated compared to firms which use the depreciated actual cost for valuing their assets and which optimise the value of the assets
- An assessment based on the RAB will not reflect the actual investment made by shareholders of the network whereas under more conventional approaches, equity comprises capital injections plus retained profits
- Assuming a level of gearing as the AER does and applying this to the RAB, a return on equity can be understated when compared to the returns on equity achieved by the larger cohort of firms using conventional methods of setting the asset base

Because the RAB is required to be based on a depreciated replacement cost of the plant and equipment provided by the network, and where there is no requirement to devalue under- or un-used assets, this means that the RAB includes a considerable amount of inflation and the full value for assets ever when they do not contribute to generating profits. In contrast, firms in the competitive environment assess their asset base on a depreciated actual cost basis[1] but also exclude other assets which do not contribute[2]. The MEU considers that measures of profitability between regulated firms and firms operating in the competitive markets need to be carried out on a consistent basis for asset valuation.

The MEU has observed that the financial statements for regulated networks separate out the inflation component of RAB into a separate line item (such as a revaluation reserve[3]) in order to have their financial accounts consistent with accounting standards used by all firms. In theory, subtracting the revaluation reserve from the RAB would be part of delivering an asset base similar to a depreciated actual cost approach, but an assessment also needs to be made of what assets are surplus to needs and these have to be removed from the asset base. This would provide a level of consistency for comparison purposes.

With these thoughts in mind, the MEU has concerns that unless the AER uses conventional approaches to setting the asset base, any financial assessments developed using the RAB will not be comparable to the approaches used in the wider market for assessing and comparing profitability.

[1] The MEU is aware that some firms do revalue some assets when circumstances change (eg when an office building becomes fully tenanted or land is rezoned) but the bulk of assets (eg plant and equipment used by firms to generate their revenue) are recorded financially on a depreciated actual costs basis
[2] This is done through a devaluation (effectively a re-optimisation) or write off of these assets
[3] The MEU notes that the revaluation reserve is considered to be part of equity and receives an equity return. The MEU notes that as the rate of return is a nominal value, applying a nominal rate of return to inflation included in the RAB is effectively applying double inflation costs to consumers.

The impact of tax

The MEU is aware that the amount of tax actually paid by networks is consistently less than the amount of tax assumed to be paid under the post tax assessment for the building block approach. This means that a measure which excludes the impact of any tax benefit will not provide a comparable profitability measure or allow an assessment of where any excessive profits are being generated from

The extent of debt used

The MEU has noted that in developing the gearing to be applied to the rate of return formula for networks (S-L CAPM) the AER has assessed the share of equity by deducting the amount of debt in the financial statements of the networks from the RAB. If the amount of interest paid by a network is less than that assessed by the AER, this distorts the process of setting the gearing assumed to be typical for a network.

The MEU has observed that the cost of debt incurred by the networks has consistently been lower than the cost of debt allowed by the AER in its weighted average cost of capital (WACC) assessment[4].

An understatement of the cost of debt leads to a view that the network has a lower gearing than in reality.

Other aspects

The MEU is also aware that there are other aspects of financial assessments which will impact on comparisons, such as abnormal adjustments and goodwill, that will need to be assessed.

The MEU considers that there needs to be a cohort of capital intensive firms that need to be developed to provide a comparison basis for the network profitability

[4] While not the focus of this assessment of profitability The MEU considers that under an incentive regulatory regime there should be a mechanism for consumers to benefit from the ability of the networks to incur lower debt costs than that allowed by the regulator (such as is applied to opex which is another cost to the network), but while the AER has provided structure for a cost of debt allowance that allows the networks to seek lower cost ways of accessing debt, there is no way for consumers to access this benefit over time.

MEU assessment

The MEU considers that having just one measure to assess network profitability will be insufficient for the needs of the AER and stakeholders and that a number of profitability measures would be more appropriate to identify if there is excessive profitability and from where this higher profitability might be generated.

The MEU notes the preference of McGrathNicol report which considers earnings before interest and tax related to the RAB provides the best measure to be used. The MEU agrees that if all firms are measured on the same basis, then it would agree that this measure has considerable merit. But the impacts of

- an overstated regulatory asset base (through inclusion of inflation)
- the incentive schemes (EBSS, CESS and STPIS)
- the games played by networks in relation to gamma and their tax liability
- the gearing approach used by the AER in its WACC formula
- the ability of networks to pay less interest than that awarded by the AER

all conspire to distort the “purity” of an EBIT/RAB comparison with the wider cohort of capital intensive firms operating in the market.

While the MEU agrees that EBIT/asset base (providing the asset base excludes inflation and optimisation) is a useful measure, it also considers that an assessment of the net profit after tax and interest (NPAT) measured against the actual depreciated value of optimised assets will provide two useful measures that will allow a good comparison and allow some a better comparison for the financial performance of the networks with the market more generally.

The MEU notes the McGrathNicol assessment for NPAT meets the criteria well except for criteria 2 (manipulation of data) and 5 (comparable to other businesses). The MEU disagrees with the McGrathNicol assessment of using NPAT when it is considered that regulated firms are different to other businesses in the way their revenue is delivered. In particular, the setting of the regulated asset base is unique amongst the cohort of the firms for which comparisons will be made.

The MEU has also noted that some regulated networks have shown in their financial reports that the amount of equity actually provided by the shareholders (ie the capital initially injected plus new injections plus retained profits) is consistently less than the proportion of equity assumed in the AER WACC formula. The MEU therefore suggests that a secondary measure should be NPAT related to actual equity injection and this should be compared with that of other firms in the cohort. The MEU notes that the McGrathNicol traffic light approach indicates that they also see this measure would be useful.

In light of the foregoing, the MEU considers that the AER should not try to apply one measure for the assessment of profitability but to use a suite of measures. The MEU considers that this suite should include:

- EBIT/assets
- NPAT/assets
- NPAT/equity

taking particular note that

- the valuation of assets needs to be made carefully to exclude elements which are not consistent with valuations used in the wider cohort of comparator firms
- the assessments of equity should be made on the basis of capital injections and retained profits
- the cohort of comparator firms should be capital intensive and operating in a competitive environment.

The MEU is happy to discuss the issues further with you if needed or if you feel that any expansion on the above comments is necessary. If so, please contact the undersigned at [redacted]

Yours faithfully

[redacted]

David Headberry
Public Officer