AUSTRALIAN ENERGY REGULATOR

Meeting summary— 13 September 2019 Key Issues and Action Items

TO: Profitability Measures Review Working Group (PMRWG)

CC: Warwick Anderson

SUBJECT: Summary of outcomes from the PMRWG meeting 13 September 2019

The PMRWG met on 13 September 2019 as part of its ongoing engagement to work through issues raised in response to the AER's draft position paper for the review into profitability measures that can be applied to electricity and gas network service providers (NSPs). The agenda was:

1. Opening remarks / update on work program
2. Return on regulatory equity – Background and overview
3. Determination of tax expense
4. Allocation of interest expense
5. Next steps

For items 2 to 4, AER staff (we) provided a summary of the draft position paper and technical advice provided by PricewaterhouseCoopers (PwC), presented stakeholder views in response to the draft position paper and PwC's advice, and put forward our own views for discussion. For agenda items 3 and 4, we put questions to the PMRWG to help guide the discussion.

The following is a summary of the outcomes of this meeting.

Opening remarks / update on work program

We provided an update on the forward work plan, key issues for discussion and the indicative timing of future PMRWG meetings.

Return on regulatory equity – Background and overview

We proposed to maintain the draft position that return on regulatory equity (RoRE) be included in the suite of profitability measures to be reported because:

- a net profit after tax (NPAT) based measure is a more complete comparison of actual outcomes against allowed revenues. This is an essential outcome of the review
- it allows the NSPs' actual returns to be directly compared to the returns on equity allowed in revenue determinations. This is one of the objectives of this review, and
- it provides stakeholders with a widely accepted and commonly used measure of the actual/ultimate returns to their shareholders/owners.

Calculation and comparisons of RoRE measure

We set out the RoRE would be calculated as regulatory NPAT divided by regulatory equity. The RoRE outcomes would be compared against the post-tax real returns on equity:

- allowed in the NSP's regulatory determination over time
- other NSPs in the sector, and
- other regulated businesses outside of the sector where the asset base is valued on a reasonably consistent basis, and the debt to equity mix is similar.

To determine the regulatory NPAT, we noted the main challenges arise in the determination of actual tax and interest expenses at the level of the individual NSP, noting that:

- we do not have a consistent reporting framework for this information
- some NSPs (flow-through entities) do not incur tax or interest expenses directly as it is managed at the corporate group level
- these NSPs may not have visibility of their owners' tax circumstances which, as per the AER's tax review, is the relevant level at which we would consider actual tax for flow-through entities, and
- debt is often raised at the group level.

To address these limitations and to ensure the RoRE measure is meaningful, we will provide:

- guidance to NSPs on how to determine actual tax and actual interest expenses. We will publish any such guidance to assist stakeholders in interpreting the measures, and
- provide explanatory material to highlight the factors that can impact the regulatory NPAT and subsequent RoRE to guide stakeholders in interpreting the measure.

Determination of tax and interest expenses and the advice sought from PwC

We noted that to assist with our preparation of guidance, we sought advice from PwC on methodologies to determine the NSP's applicable tax and interest expenses for reporting NPAT on a regulatory accounting basis. PwC's advice informed our working group discussion.

Tax review and the binding rate of return instrument

We noted some of the issues in developing the RoRE measure are linked to issues addressed in the AER's tax review and binding rate of return instrument. We set out that our final position on the profitability measures reporting framework and approaches would be consistent with our approaches for these other processes, having regard to their specific purposes.

PMRWG considerations

The PMRWG noted, as reporting the RoRE was new, the data requirements and reporting will likely be subject to refinements overtime. Individual members put forward the following views:

- data requirements need to be based on what NSPs can feasibly produce
- the AER needs to take into account the NSPs' explanations and their basis of preparation documentation before applying the data to the measures
- data and initial RoRE outcomes should be sense-checked before publication, and
- any reviews of approach to determine the RoRE will need to identify whether the output from data submitted is reasonable to better understand drivers of profitability.

Action items

- There were no action items from this agenda item.

Determination of tax expense

We identified two means of determining a meaningful actual tax expense at the NSP level:

- Top-down—start with an ownership group statutory amount and divide between business units.
- Bottom-up—develop an accurate actual profit before tax figure then apply the applicable tax rate.

We proposed that, rather than 'allocate' tax from the corporate group, the most practical approach is to estimate regulatory 'actual' tax expenses by determining appropriate:

- profit before tax (PBT) positions for the each NSP, taking into account 'actual' interest expense allocated from the corporate group
- applicable tax rates, reflecting the ultimate tax-paying entities applicable tax rates from the perspective of the investor/s receiving the ultimate return on equity.

This approach recognises that:

- actual tax will not always be equal to our forecast tax allowance
- while a consistent benchmark is applied when setting the NSP's revenue allowances, not all pay the same tax rates due to their different ownership structures, and
- for flow-through entities, tax is not paid at the NSP level. As such, it is not clear whether and how these NSPs would source a single statutory tax expense from owners.

We proposed that, in forming an approach, an important aspect is whether to:

- adopt a common tax rate for all NSPs as per our tax allowance, or
- adopt different tax rates depending on the group structure, and within this approach:
  - whether to rely on entities to self-assess the appropriate tax rate, and
  - whether to specify the appropriate tax rate for particular entity structure.

The discussion with the working group proceeded in three parts, which set out:

- PwC's advice on the determination of tax expenses.
- Adjustments to the PBT position (beyond EBIT less interest expense).
- The applicable tax rates used for estimating actual tax expense for the regulated NSP.

Advice sought from PwC

For context, we set out PwC's two recommendations for determining the NSP's tax expenses.

Recommendation 1 – Tax determination for entities which are taxed as a company

For entities taxed as a company, an NSP's applicable tax expense could be derived from the income statement (as set out in our draft position paper) by multiplying the NSP's PBT by the corporate tax rate of 30%, subject to adjustments for any differences in accounting and tax that will not unwind over time (referred to as permanent differences, discussed below).

Recommendation 2 – Tax determination for "flow-through" entities

NSPs held within flow-through structures would require a separate tax calculation reflecting their corporate structure. In particular, these entities should self-assess a "blended" tax rate which would be applicable to distributed taxable profits, having regard to the nature of the project vehicle (e.g. Managed Investment Trust, Division 6C trust) and the profile of investors. For stapled structures, the "blended" tax rate would be expected to be no higher than 19.5%.

PwC also recommended that consideration be given to the applicable tax rate for NSPs held by state/territory owners which are not subject to the National Tax Equivalent Regime (NTER).

Submissions on PwC's advice

We noted submissions generally supported PwC's approach. However, submissions were divided on the tax rates that should apply, with stakeholders generally submitting that:

- it is appropriate to distinguish between actual tax paid by entities taxed as companies and those taxed as flow-through entities (i.e. agreeing with PwC's advice), or
- recommending that all NSPs use a 30% tax rate, regardless of ownership structure.

Submissions also considered the treatment of depreciation will be an important aspect, noting:

- an adjustment to recognise the indexation of the regulatory asset base (RAB) may be needed if the PBT calculation starts with EBIT and adds back regulatory depreciation
- post-tax revenue model (PTRM) tax depreciation be used because the tax asset base is not indexed, alleviating the need to adjust for the indexation of the RAB, and
- although use of PTRM tax depreciation would result in a lower amount of tax payable (and thus higher profitability) attempting to calculate the "correct" amount of tax depreciation would be a monumental task, which may not provide an accurate result.

Adjustments to PBT for permanent differences

We noted that, in determining the actual regulatory tax position, an NSP's initial PBT position will require adjustments for any differences that will not unwind over time due to differences in accounting and tax (referred to in PwC's advice as 'permanent differences'). We set out our preliminary views on the three categories of permanent differences identified by PwC.

Deductions relating to capital expenditure (depreciation expenditure)

A permanent difference arises as the NSPs' RABs are indexed whereas their actual tax fixed asset registers are not. PwC considered that ideally the impact of indexation on regulatory depreciation be identified to make this adjustment, or at least, apply a formula which provides a reasonable approximation of what this amount would be.

However, our preliminary view was to adopt the NSPs' proposed approach which uses tax depreciation from the tax-asset base (TAB) to make this adjustment because:[1]

- TAB valuations are not indexed which should isolate the inflation effects to be removed
- the TAB is updated consistently with the RAB for capex and so should properly capture the TAB to be depreciated within the appropriate regulatory ring-fence
- it is simple, transparent and likely to be as accurate as any other general approach.

Deductions relating to interest expenditure

[1] For example, the APGA submission pp. 3-4.

NSPs should make (where applicable) the following interest expense adjustments, as per PwC's advice:

- any interest expense disallowed for deductibility under Australia's thin capitalisation regime, or assessed to be from an equity instrument for income tax purposes
- where hybrid mismatch rules apply to deny a debt deduction which gives rise to a hybrid outcome (e.g. interest is otherwise deductible in Australia, but not assessable on receipt in another jurisdiction), and
- where the accounting and tax classification of an instrument differs (e.g. debt v equity).

Adjustments to prior year returns

NSPs should make (where applicable) the following prior year return adjustments, as per PwC's advice:

- where prior year income tax assessments for regulated businesses are amended following dispute with the ATO or a change in law (such as a Court judgement), and
- where the income or expense in question is within the regulatory ring-fence and the adjustment is permanent in nature.

For discussion:

- Whether the working group has views on:
  - Our preliminary views, as described above.
  - Any other necessary relevant adjustments for "permanent differences" to get to an appropriate 'true' PBT position for estimation of tax expense?

Applicable tax rates for different ownership structures

To determine the applicable tax rates, we proposed the approach of specifying tax-rates based on the NSP holding structures:

- NSPs taxed as a company – tax rate of 30%
- NTER entities – an effective tax rate of 0%, based on our findings in the AER tax review that owners of the assets are likely to be indifferent between tax payments and dividends.
  - alternatively, a tax rate of 30% apply, reflecting the rate applied for determining NTER payments. The explanatory material would note the tax implications of the ownership structure.
- Flow-through State Government owned entities not subject to NTER – tax rate of 0%, reflecting that these entities submitted to us during the AER tax review that, while they do not currently pay tax, they paid the state government a one-off NTER equivalent prepayment as part of the transaction process.
  - alternatively, a tax rate of 30% apply, on the assumption that the prepayments had been accurately forecast over the life of the asset, recognising in the explanatory material that these entities are not currently paying any tax.
- Other flow-through entities – self-assess a "blended rate" based on their ownership composition (subject to guidance). Rates to be determined on a best endeavours basis using information from investors or assumptions from other available information.

We indicated a preliminary view that NSPs in flow-through structures are best placed to self-assess a blended tax rate having regard to their ownership composition. We recognised that an initial allocation may be complex and incur some costs. If the flow-through entities are able to self-assess, our view is that PwC's 'base case' (based on PwC's advice the rate should not be higher the 19.5%, and lower in most cases) is a reasonable reference point that stakeholders can compare against their self-assessments. In the event that self-allocation is infeasible, we suggested that 19.5% could apply more generally across flow through entities noting that—it is likely to be less precise than self-assessment, however in our view it is preferable to relying on 30% for reporting *actual* tax. The benefits of this option are it is relatively simple, transparent and more meaningful than an assumed tax rate of 30%.

Impact of franking/imputation credits

Within the working group meeting, we also provided a verbal addition to the working group discussion papers regarding the treatment of imputation credits. We noted that the treatment of imputation credits in the RoRE presumes investors are incorporating the value of imputation credits in their returns. This raises the question of whether or not estimated actual returns should be adjusted for imputation credits. We noted that we have not currently formed a view on whether an adjustment to the RoRE calculation would be made or whether it is better described contextually in explanatory material rather than an adjustment.

For discussion:

- We seek the working group's views on our preliminary views regarding:
  - estimation of the tax expense using the regulated entity's profit before tax and an applicable tax rate
  - incentive effects of using applicable tax rates which reflect the entity's holding structure, rather than reliance on 30 per cent
  - whether it is practically feasible for flow-through entities to self-assess a meaningful blended tax rate
  - if we were to adopt our proposed approach, our preliminary views on applicable tax rates for different company types

PMRWG considerations

The PMRWG supported use of a 'bottom up' approach to determine tax expenses noting:

- some NSPs would find it difficult to develop a top down allocation of tax expense
- although a 'top-down' approach may be more accurate, a 'bottom-up' approach is more transparent and will assist stakeholders to understand the amount more straightforwardly than a 'black box' top down allocation.
- the use of TAB depreciation seemed reasonable but noted the approach may need to be reviewed once results are available.
- there may be confidentiality issues with publicly disclosing adjustments arising from ATO disputes. These will need to be dealt with on a case-by-case basis.
- application of different tax rates needs an explicit statement in the explanatory material for the different treatment of entities.

The PMRWG generally supported the use of self-assessed blended rates for NSPs part of flow-through structures. Individual PMRWG members put forward the following views:

- the limitations on availability of upstream investor tax rates needs to be made clear when applying blended tax rates
- some 'testing' of the blended rates should be done before being used
- NSPs need to explain their approaches for determining the blended-rate so it could be sense checked by stakeholders
- the AER could potentially substitute an alternative rate where a self-assessed rate was considered 'inappropriate'.

In response to these views, we noted that where we have concerns about the NSPs proposed rates we would consult with the relevant NSPs on our concerns. We made clear that if we deemed a need to substitute a tax rate, we would need to consult, prior to substitution occurring. The PMRWG supported this approach.

The PMRWG generally accepted the basis for our view that a 0% tax rate applied to NTER entities however noted that it was important clarification be provided that the NTER payments into consolidated revenues are used to provide public services and assets. (Application of a 0% tax rate for NTER entities was revisited at the PMRWG meeting on 15 October 2019).

Action items

- AER to consider further its position and approach to adjust RoRE for imputation credits.
- AER to consider further how it will manage adjustments to tax expense following ATO disputes where there are restrictions

Allocation of interest expense

We noted our endorsement of PwC's proposed methods for allocating interest expense from the corporate (statutory) level to the NSPs for the purpose of calculating the RoRE (**Table 1**). On balance, we recommended a possible approach where we would:

- requiring NSPs use method 3 (NSPs self-assess) as the primary approach, and
- also report an allocation under method 1 or ENA's proposed approach (set out below) as a reference point for stakeholder comparison.

Table 1: *PwC's proposed methods for allocation of interest expense*

Method No.	Allocation Methodology	Advantage	Disadvantage
1	**Allocation based on regulatory EBIT / Statutory EBIT**	Simplicity and ease of interpretation	Lack of comparability where profitability of regulated assets is materially different to profitability of unregulated assets
2	**Allocation based on RAB / Statutory Non-Current Assets (excluding DTAs)**	Simplicity and ease of interpretation. Greater relevance of assets as a driver of financing costs.	Allocation requires development of unindexed RAB values, otherwise it may be skewed by indexation of RAB and/or revaluations of assets for statutory reporting purposes

3	**Specific allocation having regard to use of funds**	Accuracy	Complexity and cost of administration if information not readily available to businesses.

We noted that, consistent with PwC's advice, method 3 should be preferred as it is most likely to result in a meaningful and accurate interest expense allocation. However, it raised the following issues:

- consistency - whether all NSPs will be able to prepare an estimate on this basis, and
- transparency - whether stakeholders will have sufficient opportunity to understand and evaluate the assumptions used in the allocation.

Also consistent with PwC's advice, we considered that where NSPs are unable to develop a specific allocation, a general allocation approach (such as PwC's methods 1 and 2) could be considered in light of the NPS's circumstances and the disadvantages of the method. We endorsed PWC's position that NSP's report the allocation method they used, for transparency.

Submissions from stakeholders on PwC's advice

We noted submissions were divided as to whether the NSPs should be allowed to choose an allocation method or whether we should require the NSPs to use a particular method.

We noted that overall submissions supported method 3 as the preferred option on the basis that NSPs are best placed to calculate a bespoke allocation and this would result in the most accurate interest expense allocation. Submissions considered that accuracy of the approach should be given priority over the simplicity of the other methods.

It was proposed that where NSPs depart from method 3, they should justify their reasons and the AER should decide whether the justification is reasonable.

Submissions generally agreed that method 1 provides a simple and relatively easy allocation approach however were divided as to whether it should be used. Submissions against using method 1 were of the view that the differing and varying levels of risk and profitability between regulated and unregulated parts of the business could skew outcomes.

On balance, submissions did not support method 2 on the basis that the different treatment of regulated and unregulated asset values could also skew outcomes.

Alternative interest allocation methods proposed by submissions

We noted some submissions had put forward alternate methods to allocate interest expense:

- APA Group and Australia Pipelines and Gas Association proposed: RAB multiplied by 60% gearing ratio multiplied by the AER determined cost of debt.
- ENA proposed: Regulated Business Statutory Property, Plant and Equipment (PP&E)/Statutory PP&E, then RAB/Regulated Assets. The interest expense would be allocated across all businesses in a group based on their relative share of statutory PP&E. If necessary, the interest expense would then be split between the regulated business units based on their relative RAB proportions.

Our preliminary views on interest allocations

We noted the objective of allocating interest from the corporate group to the NSP is to capture the effects on profitability of differences between actual debt financing (practices and

outcomes) and our allowance. These differences might arise because of factors including, but not limited to:

- rates achieved by NSPs in debt markets (holding other factors constant) are lower or higher than the yields estimated through our approach to the return on debt
- characteristics of the NSP that affect overall portfolio costs are different to the characteristics we assume in setting our allowances (e.g. gearing, term, etc.), and
- debt raising practices that affect overall portfolio costs are different to the characteristics that we assume in setting our allowances (e.g. hedging practices etc.).

Our intention in the initial instance is not to decompose these factors. However, to the extent the analysis produces notable results, it may prompt us to request further information to understand the differences.

In the remainder of the discussion, we set out our preliminary views and questions on:

- the two roles of interest expense in transformation of EBIT to NPAT
- implications of the regulatory ring fence
- reliance on one or multiple allocation approaches, and
- pros and cons of specific allocation options.

The two roles of interest expense in transformation of EBIT to NPAT

We noted the determination of regulatory interest expense serves two purposes:

- an input into the estimation of the regulatory taxation expense of the NSP; and
- an expense in its own right to be removed from EBIT in getting to NPAT.

As such, the two numbers could be different due to differences between the NSP's interest expense incurred and the deductibility of the expense to determine the NSP's tax expense (one of the possible 'permanent differences' identified by PwC).

Implications of the regulatory ring-fence

We noted that interest expense would likely be observable at the ownership group or financing entity level. So, the allocator must be able to meaningfully allocate interest expense between:

- the regulated entities to which the financing entity or ownership group relates, and
- unregulated entities.[2]

We also noted that the following factors would need to be removed to ascertain an interest expense incurred only for the NSP's regulated activities:

- merger and acquisition activity (e.g. privatisations), where the quantum of actual debt assumed by the NSP will be based on the market value of the regulated assets at the time of acquisition (at an appropriate gearing ratio), and
- actual interest expense of the NSPs reflecting debt used to fund acquisition or construction of both regulated and unregulated assets.

For NTER entities, we note that option 3, requires an interest allocation based on the use of funds. If debt is held which does not relate to funding of the regulated business activities, it should not be included in the allocation of the interest expense.

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[2] Note: the NSP will not need to distinguish between the various different unregulated entities.

Further, our preliminary view is that the interest allocation for NTER entities should in principle reflect the interest rate faced by the financing body rather than the equivalency payment charged by the financing body to the NTER entity.

Reliance on one or multiple interest allocation approaches

We noted that PwC's interest allocation methods can be considered a choice between:

- simple, 'general' allocators based on a relevant driver (methods 1 and 2), and
- a more sophisticated 'specific' allocation developed by individual NSPs with respect to their particular circumstances (method 3).

We considered the methods could be alternatives or complements, with more than one method reported. For example, we could mandate use of method 3 (the primary estimate), and request or develop alternative estimates using one or more of the general allocators to provide reference points to test the sensitivity of the NPATs to different assumptions.

Further, in response to input from the working group, we recognised that a self-assessment (option 3) might rely on a range of different techniques to allocate different types of debt within entities. For example, there may be some proportion of specific-purpose debt which can be directly allocated to a specific business unit, and some amount of 'general' debt which might rely on a different allocation approach. To that end, the self-assessment approach might *include* some components allocated using options 1 or 2.

For discussion:

- Should a single method be prescribed for the allocation of interest, or is it preferable to report using multiple measures?

Information to be provided in support of allocation (Information in support of allocation)

We noted the importance of clearly defining expectations about the supporting information NSPs should provide if they self-assess their actual interest expense (option 3) so as to provide transparency of the approaches they apply (reflecting their individual circumstances). This is especially important where we rely on option 3 (self-assessment) so that stakeholders have sufficient guidance about allocation methodology to have confidence in the data.

We recognised some level of detail (e.g. rates and counterparties on specific individual debt instruments) is likely to be commercially sensitive and so may not achieve the purpose of being publishable to promote transparency. However, there are particular items of supporting information that will be important to include for stakeholder evaluation that include, but not limited to:

- the implied book-value gearing for the NSP to guide interpretation of the estimate
- an implied average rate on the debt portfolio that stakeholders could compare against (for example) the yields we estimate using our return on debt estimation approach, and
- detail on the allocation of interest expense between regulated and unregulated units.

For discussion:

- Whether there are any additional types of information that should be expected as part of the basis of preparation
- Whether the working group recommends any changes to the options above

Advantages and disadvantages of specific allocation options

We set out our view of the advantages and disadvantages of PwC's allocation approaches.

We reiterated method 3 (self-assess) was our preferred method as it was likely to provide the most accurate allocations. However, we questioned whether all NSPs could prepare an estimate on this basis and the lack of transparency of the NSPs allocation approaches.

We set out our assessment of the advantages and disadvantages of methods 1 and 2 against the criteria developed by McGrathNicol to test the appropriateness of financial performance measures applied to the NSPs (**Table 2**).[3]

Table 2: Appropriateness of interest allocation method 1 and method 2

Criterion	Details	Method 1 Allocation based on regulatory EBIT / Statutory EBIT	Method 2 Allocation based on RAB / Statutory Non-Current Assets (excluding DTAs)
1	Requirements are based on clear concepts and performance measures are able to be calculated consistently over time.	Yes	Yes
2	Calculation does not require significant manipulation of data, or require assumptions to be made. The measure's calculation is not significantly impacted by accounting adjustments, taxation treatments, or the entity's financing structure.	Yes	No. The allocation can be skewed by the indexation of the RAB and the revaluation of assets of the service providers.
3	Generally accepted by industry experts as a good measure of profitability, and easily understood and meaningful to persons without a financial background.	Yes	Maybe. The allocations are based on balance sheet allocations and do not relate to the profitability during the year.
4	Suitable given the industry characteristics (e.g. capital intensive, long life assets, regulated revenue and returns).	No. Any material differences between the profitability of regulated assets and the profitability of unregulated assets may prevent suitability.	Yes
5	Readily able to be compared to other businesses in the sector and other businesses in the broader economy.	No. Any material differences between the profitability of regulated assets and the profitability	No. The indexation of the RAB may prevent comparability to other businesses.

[3] McGrathNicol, *Response to submissions on profitability measures, 23 April 2018*, p. 7.

		of unregulated assets may prevent comparability to other service providers and other businesses.	

For discussion:

- Does the working group have any feedback on the advantages and disadvantages provided for each method of interest allocation?
- Does the working group have any feedback on the use of method 3 and method 2 (after the removal of the indexation of the RAB)?

Alternate methods

We put forward that the alternate allocation methods proposed by APA Group, APGA and ENA would not be included in the options for NSPs to make allocations on the following basis:

- Assuming actual return on debt is equal to forecast return on debt is not fit for purpose—the objective of our measures is to capture differences between allowances and actual outcomes. Such an approach would assume away those differences.
- While ENA's method has merit, there are disadvantages such as it excludes investments into intangible assets by regulated or unregulated assets which were funded by the debt held within the corporate structure.

For discussion:

- Is there another interest method allocation method (apart from the method recommended in the ENA submission) we should consider for a service provider's interest expenses?
- Do any NSP's already allocate interest expense to its regulated business activities? Is so, is the calculation similar to any of the methods provided in the PwC Report?

PMRWG considerations

Of the methods presented, the PMRWG were in consensus that method 3 (self-assess) was likely to be the most appropriate as:

- the NSPs are best placed to determine allocations based on their individual circumstances, and
- a general one size fits all simple allocation approach is unlikely to result in a meaningful measure.

Individual PMRWG members put forward the following views:

- while some debt can be allocated to specific business units, in the process of self-assessing interest expense (method 3), have flexibility to adopt different approaches for different types of debt based on their individual circumstances
- there is some further information that would be required to explain the reconciliations and whether we would require reconciliations between the estimates
- consumers are not across the level of detail as the NSPs are. NSPs will likely depend on the AER to sense check the allocation approaches, and
- the AER's role should be to provide guidance, but not preclude NSPs from a certain approach, and to investigate the data to determine the suitability of an approach.

In regard to the use of multiple measures for different observations of the interest expense allocations, the PMRWG members raised caution with this approach noting:

- multiple measures could lead to confusion over which is the 'correct' value to use. However, it could be useful for the AER to collect the data underlying all options for its own internal comparisons
- reporting multiple allocation methods would create a greater need to explore the data, and
- what information would be required to explain the reconciliations and whether we would require reconciliations between the estimates.

In regard to the information requirements to support the allocation methods, the PMRWG members noted:

- without transparent supporting information, self-assessment has the risk of material information asymmetry in understanding the estimate. Different financing practices will drive the approach, and so allocation approaches may be quite different between networks. The AER will need to be clear in its instructions and guidance about what we expect in terms of valid approaches and the supporting information requirements.
- PwC advice was that book value of asset provides a realistic snap shot of debt funding across different asset classes. The AER will need to be clear on whether the book value of assets are inclusive or exclusive of intangibles.
- if NSP's reporting of EBIT at the business unit level then the book values will be available.

Action items

- AER to provide a draft RoRE explanatory statement outlining working group considerations and clear statement on purpose of profitability reporting.
- AER to include in information requirements on book values of assets relevant standard control and total ownership group, as a relevant source of information that should be readily available. This will support the level of transparency over values used in interest allocation approaches based on statutory asset values.

General approach to data collection and RIN development

Although not a specified agenda item, the approach to data collection more generally was discussed at the working group meeting.

We set out that the information to be collected from the NSPs would likely be on a 'best endeavours' basis in the first instance due to timing and likely refinements to the process once we started to collect the data. The data collection, would as soon as practical, progress to a more formal instrument (such as a regulatory information notice) and subject to independent auditing requirements including data previously provided by the NSPs.

PMRWG considerations

The PMRWG generally supported our proposed approach. Individual members put forward the following views:

- Clarity should be provided around how the values in a RIN have been developed (e.g. blended tax rates) which should be supported by a description of methodology and supporting information.

- Information requirements need to be subject to rigours of legislative information instrument, such as a RIN as soon as possible.

Action items

- There were no action items from this agenda item.

Next Steps

The PMRWG would meet again in October to discuss any outstanding issues.