31 May 2018

Mr Warwick Anderson
General Manager
Australian Energy Regulator
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Via email: AERinquiry@aer.gov.au

Dear Warwick

AER Draft position paper: Profitability measures for electricity and gas network businesses- April 2018

SA Power Networks, Australian Gas Infrastructure Group, CitiPower, United Energy and Powercor (**the Businesses**) are pleased to provide this submission in response to the AER's Draft position paper on profitability measures (**Position Paper**).

At the outset, the Businesses note their support for the AER's approach seeking to identify profitability measures that will allow for meaningful and accurate reporting and comparison of returns of service providers. In order to ensure the reporting assists in the achievement of the national electricity objective (**NEO**) and national gas objectives (**NGO**), it will be of paramount importance that information gathered from service providers and the comparators used are fit for purpose and result in appropriate and relevant profitability measures. To do otherwise will result in information being published which is irrelevant or at worst, misleading to stakeholders.

We note the AER has already in this review taken positive steps to ensure the information published is fit for purpose. The AER decided not to publish information derived from RIN data provided by electricity and transmission service providers, because it is not currently fit for purpose and further quality assurance is required.[1] The objective of ensuring any profitability measures published are fit for purpose should continue to be a central consideration in this review process.

We note and support the separate submission provided by Energy Networks Australia in response to the Position Paper. Below we set out some key issues and observations the Businesses consider to be particularly important in this review.

AER's use of the information

A critical issue for this review is identifying how the profitability information the AER proposes to publish will be used in the regulatory process. Whether the NEO/NGO are advanced by the gathering and publication of profitability measures will depend on how the information is used.

In the Position Paper the AER indicates that its primary purpose in reporting profitability measures is to provide transparency for stakeholders. The AER indicates that it will have regard to profitability outcomes of service providers as part of its regulatory determination processes, but it will not use the

[1] Position Paper, page 31.

information in a mechanistic way to make adjustments to allowed revenue.[2] Rather, the profitability information would be contextual, along with other information such as expenditure and service performance outcomes from previous regulatory periods.

While it is helpful to have some further guidance on what the information will not be used for, its contextual use remains unclear. It is important for there to be certainty and stability in the decision making process, including in relation to how the profitability measures will be used and how the information could in fact be applied to any part of the building block decision. The Energy Networks Australia submission suggests that two key principles could be used to define how the profitability measures could be taken into account:

1. If profit out-performance is due to out-performance of benchmarks set in the incentive framework, for example, out-performance of operating expenditure allowances, then there is nothing further for the AER to consider. Such out-performance is consistent with the incentive based framework and, using this example, operating expenditure benchmarks would be adjusted in the subsequent period regulatory determination.
2. If profit out-performance is due to factors outside of the incentive framework, for example, due to changes in interest rates, then the AER could take that out-performance into account in a contextual way in its regulatory determination process. However the AER's consideration would need to be symmetrical, so that any under-performance also needs to be taken into account by the AER in considering the overall context of its decision.

The reasons for any over or under-performance of a service provider against its regulatory benchmarks should be easy to identify. The Businesses encourage the AER to provide further guidance on the contextual use of profitability information and putting in place parameters for use, such as those summarized above. Clarity on the use of the information by the AER would benefit all stakeholders and enable better engagement on the information that should be gathered and published.

Regulatory Accounts v Statutory Accounts

The Position Paper notes that one key objective of the review is to identify measures that will allow comparison of profit outcomes of regulated networks against the broader economy. The difficulties of undertaking that comparison are rightly noted by the AER, given regulated networks are operating under a regulatory accounting framework and unregulated businesses operate under a statutory accounting framework. McGrath Nicol note that the differences could be substantial. We consider there to be core conceptual differences between the two measures that will make any meaningful comparison extremely difficult.

The AER identifies two options to make the information more comparable:

1. Adjust and amend the regulatory accounts to better align with statutory accounting information.
2. Require service providers to report information on a statutory basis.

The AER indicates that it considers the second of these two approaches to be preferable.

[2] At page 5.

All service providers will keep their internal accounting information in different ways. Regulatory accounts currently prepared by service providers will be on different bases and assumptions, as evidenced by the difficulties identified by the AER in publishing information taken from electricity distribution and transmission RINs. So the starting point for a transition to reporting on a statutory basis will be different for each business and the process of moving to that form of reporting will be complex.

Beyond this, however, there are fundamental conceptual differences between statutory accounts and regulatory accounts, given the discretion and flexibility available to a firm in a competitive market using only statutory accounts, compared to the constraints on the reporting by a regulated firm , for example in determining the RAB. This is addressed in more detail in the ENA submission. The Businesses consider that a better approach to ensure profitability reporting is fit for purpose and enables meaningful comparison between regulated networks and the broader economy is to develop standard form regulatory accounts specifically prepared for the purpose of profitability reporting. The development of purpose built accounts would be undertaken in consultation with and based on input from all stakeholders, including consumer groups.

It is acknowledged that the design and preparation of such accounts would be a time consuming process, but this does not mean it should not be done, nor that some interim form of reporting cannot be provided.

The Businesses support the two stage approach suggested in the Energy Networks Australia submission whereby:

1. A focused working group consisting of network, consumer and AER representatives target a set of guidance and achievable set of regulatory accounting based metrics. However, this would be an interim measure which will necessarily be subject to limitations, but will enable some form of information to be published within a relatively short timeframe.
2. The AER then engage with all stakeholders in a more detailed development of a set of robust accounts which can be used for profitability reporting are developed for longer term use.

Individual profitability measures

Return on Assets- (Regulatory EBIT/RAB) and return on equity (regulatory NPAT/equity share of RAB)

Table 1.1 of the Position Paper proposes to compare the Regulatory EBIT/RAB with real pre-tax WACC allowed in a service provider's regulatory determination and the NPAT/equity share of RAB with the real return on equity. These are not comparisons on an "apples for apples" basis. While there may be similarities between the ex-post metric and its ex-ante proxy, they are not in fact the same thing and differences can arise depending upon how certain items are treated, and through the operation of inflation.

Rather than the comparisons proposed by the AER, the Businesses submit that the PTRM should itself include a calculation of the Regulatory benchmark EBIT and regulatory benchmark NPAT which is based on PTRM inputs. Stakeholders can then compare the benchmark with the actual (for both the line item and the ratio; the PTRM already contains the RAB) outcomes on an apples with apples basis.

Further consultation is needed to identify the precise comparators and how they are to be derived, as well as model changes that may be required, for example to the PTRM. However, we expect these to be minimal.

Earnings per customer/connection

As the Position Paper notes, this proposed measure is not supported by service providers because it is unlikely to provide any meaningful comparisons. It is not clear that it is supported by customers either. The Businesses disagree that earnings per customer/connection can be easily understood and interpreted, given that differences will arise between service providers due to customer mix (large and small customers) customer density, business size, connection types and geography.

We remain of the view that earnings per customer/connection is not an appropriate measure of profitability and do not consider publication of this information will assist in the achievement of the NEO and NGO because:

1. It will likely result in misleading comparisons due to the limitations identified above (customer mix, density etc), nuances which are not easily adjusted for.
2. Customers are unlikely to appreciate if the reported earnings per customer is within a reasonable range. It is also likely customers will assume the earnings is profit earned by shareholders per residential customer, which it is not. For example, the measure does not take into account interest and tax expenses.
3. Customers are likely to compare this measure to their own bill, which comparison will not provide any meaningful information.
4. It is therefore likely to result in confusion and incorrect assumptions being made by customers about profitability, undermining confidence and certainty in the regulatory process.

Sufficient information about EBIT performance will already be captured in the AER's EBIT/RAB measure. We do not consider this measure will add anything to the other measures and has the potential to undermine the overall aims of profitability reporting, to provide increased transparency, improve stakeholder participation and ultimately assist in the achievement of the NEO/NGO. These aims cannot be achieved if the information published is potentially misleading.

If the measure is retained, at the very least it should be renamed 'Earnings EBIT per customer' or something similar. Further, the AER should include a note to state that it is prior to interest and tax expense being deducted. This will make it clearer to the reader what is being measured and reported.

RAB multiple

The Businesses remain concerned about the use of RAB multiples as a profitability measure. Our primary concerns are that:

1. RAB multiples are of limited use given, as the AER recognizes, there are many factors in addition to expected returns that can influence a RAB multiple.
2. To the extent they are relevant, a RAB multiple for a particular acquisition will only be relevant for a limited time after the transaction as it represents the price paid based on a certain state of affairs, the regulatory risk and framework as it exists at the time, etc.

These issues mean that care needs to be taken in how RAB multiple information is used as a profitability measure. The Businesses support the suggestion in the Energy Networks Australia submission that guidance be taken from ACCC Special Economic Advisor Darryl Biggar's paper on RAB multiples. This could provide a benchmark for the evidentiary threshold that needs to be crossed before RAB multiples can be considered useful and any use should be subject to the key principles for use summarized on page 2 of this submission.

General

An issue that relates to all of the proposed measures is the potentially material impact of the "bushfire problem" outlined in the concurrent expert sessions in the rate of return guideline review. Profits may appear high solely because a rare event (like a bushfire has not occurred in a given year, but has been provided for via a form of self-insurance). A greater focus on *actual* profitability will assist in identifying such "bushfire problems" and the impact on profitability measures. It may be outside the scope of this review, but the Businesses consider that the AER will need to provide stakeholders with guidance on how it will treat these issues in considering the profitability measures and their use.

Summary

The Businesses are generally supportive of the AER's draft positions and objective of ensuring appropriate and informative profitability measures are identified which are fit for purpose. As identified in this submission, further consideration should be given to some of the specific measures and how the reports will be prepared and used. We welcome the AER's recognition of some of the difficulties with profitability reporting and look forward to assisting to develop a reporting framework which is transparent, provides relevant and useful information for all stakeholders and assists in the achievement of the NEO and NGO.

Please contact Nick Wills-Johnson on [redacted] if you would like to discuss this submission further.

Yours sincerely

[redacted]

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