# Profitability measures for electricity and gas network businesses

Response to AER Draft Position Paper

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Energy Networks Australia

# Contents




Energy Networks Australia www.energynetworks.com.au
Unit 4, 110 Giles St, Kingston ACT 2604
P: +61 2 6272 1555 E: info@energynetworks.com.au
Energy Networks Association T/A Energy Networks Australia
ABN: 75 106 735 406

# 1 Overview

**Key messages**

- Network businesses support development and implementation of profitability measures.
- We recognise consumers' need for meaningful measures able to be used in a timely way and there are positive opportunities of getting this process right.
- There is value in achieving clarity and alignment of expectations of stakeholders about how such information will be used before data publication begins.
- An approach of adjusting statutory accounts towards regulatory accounts holds risks for complexity, transparency and acceptance of measures which will need active management.
- Close collaborative consultation will be needed to achieve robust outcomes.

Energy Networks Australia welcomes the opportunity to provide the industry response to the Australian Energy Regulator's (AER) *Position Paper on Profitability measures for regulated gas and electricity network businesses*.

Network sector supports the development of robust, transparent profitability measures. We are aware that many stakeholders such as consumer groups desire some metrics which can be used as soon as possible to provide at least some indicative information about actual profit levels. We are also aware that consumers, in particular, have a strong (and legitimate) desire to play a role in the process by which profitability metrics are developed.

Robust metrics supported by all stakeholders offer the following potential benefits:

- Increased transparency around outcomes of the AER's regulatory determinations over the medium term;
- Enabling better stakeholder participation in regulatory and policy processes, promoting outcomes consistent with the national electricity objective (NEO) and the national gas objective (NGO); and
- Promoting improved confidence and stability of the regulatory framework.

This submission is focused on four broad areas aimed at contributing to development of clear, transparent profitability measures.

A key initial concern around the set of measures the AER proposes is the potential use of a mixture of "statutory" and "regulatory" reporting measures. This mixture has the effect of introducing a lack of comparability between measures due their fundamentally different basis.

Energy Networks Australia believes that these differences risk not allowing stakeholders to obtain useful, relevant, accurate and testable information about profit levels. To mitigate this risk network businesses support:

- Ensuring at each step of finalisation of the proposed measures that there is a consideration of potential implementation costs;
- The final AER position incorporating a periodic review step to allow for assumptions on implementation costs and the use of the measures to be assessed;
- Further work ahead of the final AER position testing with stakeholders their likely confidence in a 'mixed' set of statutory/regulatory measures sought from networks;
- Discussions continuing to seek upfront stakeholder alignment on how profitability measures will be used prior to the measures being published; and
- The performance reporting framework recognising that incentive-based regulation means high profitability can be sign of successful delivery of the NEO/NGO outcomes.

Taking into account discussions at the recent AER profitability measures workshop, Energy Networks Australia proposes a two stage approach of:

1. A focused working group of network, consumer, and AER representatives targeting a clearly achievable set of regulatory accounting based metrics initially; and
2. Involving all stakeholders in more detailed development work on any statutory account reliant measures, to ensure community wide confidence in results.

This approach is considered the best way to ensure that all stakeholders play an active role in the development of a robust regulatory accounting framework for use by the AER in a timely way. If implemented, it would assist greatly in giving ownership of the final product to all parties.

# 2 Clarity on use of profitability measures

Energy Networks Australia welcomes the discussion in the Draft Position Paper as to how the AER proposes to use its profitability information. The AER notes:

> *Our primary purpose in reporting the measures is to provide transparency for stakeholders on the profitability of the service providers. We intend to publish the measures (including our analysis of the outcomes and any relevant caveats) in annual performance reports for gas and electricity businesses. We consider this additional information will assist stakeholders in making submissions to our regulatory determination processes and other regulatory reviews.*
>
> *We will have regard to profitability outcomes of the service providers as part of our regulatory determination processes. However, the information would not be used in a mechanistic way to make adjustments to allowed revenues. Rather, the information would be contextual, along with other information such as expenditure and service performance outcomes from previous regulatory periods.*

*Profitability outcomes may also be used by us and stakeholders as an additional factor by which to monitor the overall effectiveness of the regulatory regime in achieving the national energy objectives.*[1]

To further advance clarity amongst all stakeholders in how the future published information will be used, network businesses consider further work should be undertaken in developing clearly understood and agreed principles of the use of profitability measures. Under an incentive regulation framework two key principles of use should be:

- If the profit out-performance is due to outperformance of benchmarks set in the incentive-based regulatory system, such as opex out-performance, then no specific response is necessary - at the next reset or review of incentive schemes this will be considered, and it is most likely to be an indication of incentive-based regulation working as it should.[2]
- If profit out-performance is due to something outside the incentive framework (for example, movement in interest rates) then the AER will need to be symmetric in its treatment of the issue, and the AER should be clear in the final position due in August how it would propose to treat these matters in a symmetric fashion.

These two principles would not only guide stakeholders in respect of what the AER might do, but would also serve to guide stakeholders themselves as they analyse the data and make representations to the AER.[3] If a business sought to make use of actual returns data that showed under-performance, it would need to make a case that its underperformance was not simply part of the ordinary and expected operation of the incentive regulation framework. The same would be true in relation to evidence of outperformance raised by other stakeholders. Having this principle in place will assist in maintaining the integrity of the incentive regulation framework, which is in the long-term interests of consumers.

In addition to the framework and principles outlined above, there is also the need to ensure clarity and shared expectation around interpreting the results taking into account infrequent events impacting costs and profitability. An example discussed in the first Rate of Return guideline concurrent expert evidence session on 15 March 2018 was that a network business might face a one-in-ten year bushfire risk which, when it occurs, causes $100 million in expenses to replace assets etc. If there is no bushfire in a given year, the $10 million of “extra” profits (say when comparing benchmark with actual EBIT) is not profit, but rather funds in the nature of self-insurance to be set

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[1] AER, Position Paper on Profitability measures for regulated gas and electricity network businesses, April 2018, p.5.
[2] Note that there may be issues in respect of inflation, whereby levels of profit differ from the benchmarks because out-turn inflation is different from forecast inflation should be ignored if the AER is minded that the current regulatory framework is designed to deliver a real return.
[3] We would not envisage that the AER would examine in detail each and every variance in profits from expected to actual, and that it would rather undertake some form of cost-benefit analysis internally as part of its ordinary business as a prudent regulator to focus on key instances of variance. However, we also envisage that others will be interested in interrogating what will be public data, and guidance on how to do so can assist greatly in such instances.

aside to cover, for example, relevant bushfire losses.[4] Any consideration of *ex-post* profits needs to bear this in mind.

Absent of guidance there is the potential for considerable confusion and unnecessary dispute. For example, some stakeholders may seek to contend that every out-performance is real, and includes no "one-off" realisation of pre-existing risk,[5] whilst businesses might seek to explain every outperformance as an impact of self-insurance which had not been fully articulated in its original regulatory submission.

Recommendation

Discussions continue to seek upfront stakeholder alignment on how profitability measures will be used prior to the measures being published.

The performance reporting framework should explicitly recognise that incentive-based regulation means high profitability can be sign of successful delivery of NEO/NGO outcomes.

# 3 Reaching stakeholder confidence in new measures

McGrath Nicholl correctly notes that reconciling the regulatory and statutory accounts is complex. Energy network businesses consider that there is a substantial risk in an incomplete appreciation of the fact that the very basis of the two systems of accounting is different.

In practice, comparing both sets of data is not an adequate approach - it might be possible to "translate" regulatory accounts to statutory accounts if both sets of accounts are clearly specified, but this is not a mechanistic process and requires close attention. If one or other of the frameworks is only vaguely specified or is incomplete, drawing any kind of consistent picture from the two sets of information is likely to be impossible.

To provide an example, consider the denominator of any profitability ratio, the RAB in the regulatory case and the asset base in the statutory case. These are not just different numbers, but are based on entirely different conceptual foundations.

In the wider economy, where prices are set by market forces rather than regulators, each firm is free to determine the mix of the return of capital and the return on capital.

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[4] Symmetrically, there may be some benefit to the business which is expected to occur at some stage in the regulatory period; say a demand increase from a new development. If this does not occur in a given year, but is still expected to occur, then the relevant under-performance result is not actually an under-performance.
[5] Since risk has upside as well as downside, conceivably, arguments might also be made that unforeseen reductions in costs or cost saving events have occurred, so that even performance at expected levels is suspected as real outperformance.

That is, a firm might decide to depreciate more quickly and return the capital its investors have provided relatively quickly, or it might decide to depreciate relatively slowly, and pay investors more of a return on capital to account for keeping hold of their capital for longer.

A network firm regulated by the AER has no practical freedom to decide the balance between the return on and return of capital - it must use the post-tax revenue model (PTRM) and it must use the depreciation schedule in the PTRM which is straight line real depreciation. Although this is not required by the NER/NGR, in practice the AER has disallowed requests to change depreciation approaches. The RAB which results reflects this lack of freedom, and is thus in a different conceptual category to an asset base out in the wider economy. It is not appropriate to draw conclusions about true returns by comparing the two side by side.

There is no perfect solution to the above conundrum of comparability between the RAB and a statutory asset base. It would appear that the best approach would be to ensure the regulatory accounts upon which regulatory profitability metrics are developed are as robust and comprehensive as possible. This at least ensures that, when stakeholders discuss a given issue, they are clear about the basis of what it is that they are discussing.

Under a ‘mixed’ regulatory and statutory reporting framework, network businesses have concerns around the capacity of that information to result in properly comparable metrics that are well understood and which have the confidence of all stakeholders.

Recommendation

Further work ahead of the final AER position tests with stakeholders their likely confidence in a ‘mixed’ set of statutory/regulatory measures sought from networks

# 4 Ensuring robust ‘like with like’ comparisons

It is understood that the AER’s intention is to measure the actual profitability of the business concerned. In developing guidance on this issue it must be taken into account that if the aim is to measure actual profitability, then the RAB is irrelevant and what instead counts is the asset value in the statutory accounts. For internal consistency, this value should, moreover, be marked to market just as it would be in any other industry using standard sets of accounts, and asset values that are ‘stale’ book values should be treated with caution.

This is especially the case in respect of firms which have been bought and sold, and whose purchasers have paid RAB multiples of greater than one (or indeed, for symmetry, less than one) for these assets. Should the AER seek to measure the actual profits the relevant current firms are making, it needs to consider the full purchase price paid (as subsequently depreciated, or amortised for goodwill). Any other measure could be misleading in respect of measuring the actual profits of the business concerned and would simply represent a number with no connection to the actual experience of any actual network investor.

It is also important that the AER is clear what it is measuring when it makes comparisons. In the Draft Position Paper, when responding to stakeholder submissions that request like with like comparisons, the AER indicates that it would equate the EBIT/RAB measure with the pre-tax real WACC, and the NPAT/RAB measure with the real return on equity.[6] This, however, was not what network businesses have sought – rather, Energy Networks Australia has emphasised that if EBIT was to be measured *ex-post*, then the AER should include an EBIT measure in the PTRM; and likewise for NPAT.

It may be the case that, under certain sets of assumptions, EBIT/RAB is the same thing as a pre-tax real WACC. However, those assumptions are not made clear in the Draft Position Paper and, where they do not hold in a given case, the measures will deviate. It would assist transparency for all parties if the AER made the relevant changes to the PTRM to include EBIT and NPAT as outputs from that model. The model already produces the RAB. Adding these measures would ensures that stakeholders can obtain a full understanding of where the differences between actual and expected outcomes lie.

As an extension of the above point, it will be important to ensure that inflation is treated consistently throughout the PTRM. That is, if the AER uses an inflation rate of roughly 2.5 percent to convert its nominal WACC into a real WACC, it must also use the same inflation to forecast EBIT, and throughout the PTRM, to ensure consistency. Later, when actual inflation is not 2.5 percent, this will have an effect on both the actual EBIT and any metric based upon it and will mean that, as a matter of course, the actual outcome will not equal the forecast just because the actual inflation is not in line with the forecast.

# 5 Individual performance measures proposed

The set of measures the AER has proposed, potential comparability issues noted above aside, represents a reasonable balanced outcome. However, Energy Networks Australia continues to have reservations around the use of the two specific measures - the earnings per customer figure and the RAB multiples.

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[6] The draft position paper is not clear whether this is pre or post tax; we assume it would be the latter.

## 5.1 Earnings per customer

In respect of earnings per customer, Energy Networks Australia supports the AER excluding transmission from this metric, as transmission infrastructure generally has very few direct customers, and results would not be meaningful.

As outlined in the public workshop, due to significant differences in the operating environment and characteristics of distribution networks - the same basic problem exists.

If two distribution networks have differing volumes of demand from industrial and residential users, then the average per user will be very different just because industrial users tend to use much more energy than residential users. This might occur even if the two networks had exactly the same user costs (that is, both cost the same to deliver one unit of energy to a household or a factory). In these circumstances, all that a proposed earning per customer measure would do is compare the mix of users in a highly-confusing manner.

If it were the case that the per user costs of serving similar customers were not the same between two networks because one was less efficient than the other, this would be obscured by the customer mix effect, and the information would be lost.

The metric is also likely to be highly confusing or misleading for customers to interpret. In particular:

» The average residential user is highly likely to interpret a metric which is an average per user as an average per residential user. If they have a bill of $800 and observe a measure called "average operating profit per customer" of $300, they are likely to assume that nearly half their bill is network profits, which is misleading, incorrect and not supportive of confidence in the regulatory regime.

» The average residential customer may also have difficulties interpreting the fine difference in accounting between operating profit and the more normal use of the term "earnings" and assume that businesses, in the example above, are making profits of $300 per customer, rather than understanding that this measure is prior to the consideration of debt and tax. If the measure is to be used at all, then it should be called what it is; EBIT per customer.[7]

» There is no useful information in the measure which is not already contained in EBIT itself. That is, with EBIT, the AER can already (issues outlined above notwithstanding) compare actual with expected return on assets and make comparisons with the wider economy. The AER makes not gains via the additional measure. If the averages were meaningful, consumers might benefit by having a simple "ready reckoner", but since the measure is highly misleading, this benefit is lost.

For these reasons, and because there appears to be very little support among any stakeholders for the measure, it should be not be progressed.

[7] We appreciate that the average residential customer might not understand what EBIT is either, but at least the measure is not misleadingly named. ENA's overall preference is to remove the measure completely.

## 5.2 Regulatory asset base transaction multiples

The other proposed additional metric around which Energy Networks Australia has substantial comments around is the RAB multiple measure.

As discussed at the public consultation forum, Energy Networks Australia's concerns relate to the following issues:

- although each observation might be forward-looking at the time of a particular sale, they very quickly become dated;
- Dr Darryl Biggar has recently released a research paper[8] that highlights a number of conceptual and practical limitations to the derivation of conclusions from observation of RAB multiples; and
- RAB multiples may reflect external macroeconomic conditions (such as regulated energy firms lower than average correlation with market returns), meaning that investors decisions on transactions may contain little specific content on the performance of the regulatory framework.

Whilst Energy Networks Australia concurs with the AER's conclusions in 2013 that RAB multiples (transaction or stock-price based) provide no unambiguous evidence to regulators reaching specific decisions in determinations, network businesses accept that other stakeholders hold different views, and that AER has a duty to consider these views. We believe, therefore, that it is appropriate for the AER to be specific and clear about how it might take into account information about RAB multiples, as a way of dealing with the fact that this is a measure which different stakeholders have different, and strongly-held views.

We believe that Dr Biggar's research paper and other work[9] provides a useful starting point in this respect and, in particular the seven conditions Dr Biggar's paper suggests must hold in order for a RAB multiple of one to be an expected outcome.

The AER should therefore require any party seeking to use RAB multiples (whether they be above or below one) to provide evidence that all seven of these conditions have been met such that the reasonable expectation of the RAB multiple is a value of one. Once this is established, the actual RAB multiple should be assessed following the same two incentive-based framework use principles outlined above that Energy Networks Australia has suggested should underpin the assessment of profitability information in general. In this manner, evidence about which stakeholders are in disagreement can be treated in a fair, consistent and robust manner.

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[8] Darryl Biggar, *Understanding the role of RAB multiples in regulatory processes*, February 2018
[9] Frontier Economics, *Why do regulated assets tend to sell for more than the RAB?* October 2017