# Profitability measures for regulated network businesses

Response to the AER Discussion Paper

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ENERGY CONSUMERS AUSTRALIA

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Consumer confidence in the economic regulation of networks is built on good information. *Ex post* profitability analysis is a fundamental requirement.

# Introduction

Energy Consumers Australia is the national voice for residential and small business energy consumers. Established by the Council of Australian Governments (COAG) in 2015, our objective is to promote the long-term interests of consumers with respect to price, quality, reliability, safety and security of supply.

We welcome the opportunity to respond to the Australian Energy Regulator (AER) discussion paper on *Profitability measures for regulated gas and electricity network business* (Discussion Paper).

In this submission we deal with some of the more technical matters in the design of profitability analysis and reporting.

# Transparency around network profitability is critical

## The need to consider profitability

As noted in the Discussion Paper, consumer groups and the AER's Consumer Challenge Panel have raised concerns about the excessive profitability of regulated electricity and gas businesses. The Discussion Paper asserts that the current regulatory approach does not consider profitability when setting annual revenue requirements and notes 'the National Electricity Rules (NER) and National Gas Rules (NGR) do not require profitability to be considered.' The Discussion Paper continues, "While *consumer groups accept this approach, they contend that collecting and reporting information on the profitability of network businesses may assist stakeholders in assessing the revenue proposals of the network businesses and the operation of the broader regulatory framework*."

Energy Consumers Australia not only agrees with this proposition from consumer groups, our strong view is that profitability analysis – the outturn of the regulatory process – also forms part of essential 'post implementation review' of the network regulatory framework as applied by the AER. Incentive regulation is necessarily an iterative exercise in information revelation. It requires the regulator to check how the firm has performed against the terms of the settlement, and where necessary, make adjustments in the next period to deliver the best possible result for consumers.

## The Allowed Rate of Return Objective (ARORO)

The ARORO (for electricity distribution – s6.5.2 of the National Electricity Rules) reads:

> *The allowed rate of return objective is that the rate of return for a Distribution Network Service Provider is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the Distribution Network Service Provider in respect of the provision of standard control services (the allowed rate of return objective).*

The proper construction of 'to be commensurate with' is that the rate of return should reflect efficient financing costs, not that it be no less than.[1] That is, the ARORO imposes a floor and a ceiling – not just the former. When 'profit' is interpreted economically (returns in excess of financing costs) it is clear that the ARORO *does* require profitability to be considered.

It is accepted that the overall structure of the regulatory framework is one of 'incentive regulation'. Networks rightly have the opportunity to earn true profit – returns above the cost of capital – but that opportunity should only be available where they genuinely 'outperform' against cost and service delivery benchmarks, not through deficiencies in the regulatory scheme such as an allowed rate of return that is inconsistent with the rest of the building block model.

Energy Consumers Australia submits that the assertion that the NER and NGR do not require profitability to be considered is a misinterpretation of the ARORO. Indeed, the ARORO states the exact opposite. For the rate of return for a network to be commensurate with efficient financing costs means the rate of return is not much more nor much less than efficient financing costs.

## The McGrathNicol scoping study

The AER has commissioned a 'scoping study' from McGrathNicol into relevant measures of financial performance that could be applied to regulated businesses. McGrathNicol has considered a wide variety of possible measures of profitability and has concluded that a Return on Assets (EBIT/RAB or total assets) would be the most appropriate. They also indicated that three other measures may be appropriate.

In reaching these conclusions McGrathNicol has applied five criteria.

> *Criterion 1 - requirements are based on clear concepts and performance measures are able to be calculated consistently over time.*
>
> *Criterion 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.*

[1] 'Commensurate' Corresponding in size or degree; in proportion. https://en.oxforddictionaries.com/definition/commensurate

> *Criterion 3 - generally accepted by industry experts as a good measure of profitability, and easily understood and meaningful to persons without a financial background.*
>
> *Criterion 4 - suitable given the industry characteristics (e.g. capital intensive, long life assets, regulated revenue and returns).*
>
> *Criterion 5 - readily able to be compared to other businesses in the sector and other businesses in the broader economy.*

Energy Consumers Australia submits that it may be difficult to reconcile the first two concepts. To calculate profitability consistently over time will require a level of sophistication in the calculation – not least because the networks operate according to revenue constraints that are 'smoothed' rather than aligned to underlying costs.

We agree that the reporting of the metrics on profitability should be clear and understandable for informed stakeholder audiences. Manipulations of data can be performed transparently and communicated simply.

Our comments on the criteria overall follow in the next section.

### The onus of proof on regulated businesses

A known feature of regulated businesses is the information asymmetry between the regulated firm and the regulator. Frequently this asymmetry is exercised to the advantage of the regulated businesses, which requires the regulator to 'make its case' knowing full well the regulator does not have all the requisite information.

In the Discussion Paper, the AER acknowledges that it currently does not have some of the information from networks it needs to undertake profitability analysis. The AER notes that to obtain the data it will need to amend the Regulatory Information Notices (RIN) to obtain the necessary data in future.

We believe that the AER should also obtain information about historical profits. If networks are achieving rates of return in excess of efficient financing costs today, and have been doing so for some time, that needs to be identified and addressed.

In the first instance, the AER should ask the network businesses to volunteer to provide the historic data necessary to establish a longer-term view of profitability.

## Report from Newgrange Consulting

### The Newgrange perspective

Energy Consumers Australia has commissioned Newgrange Consulting to review the AER Discussion Paper and propose an appropriate process for assessing profitability. Kieran Donahue, who prepared the report for Newgrange, previously helped design Ofgem's profitability reporting framework.

The Newgrange Consulting report (Report) is provided as a supplement to this submission.

The Report provides a summary of the purposes and interpretation of profitability measures under three headings:

- comparison against *ex ante* expectations;
- comparison against other industries; and
- comparisons against other firms and over time.

The Report also notes that the interpretation of any data needs to be done with care and presented in a way that consumers and other stakeholders can engage with it.

In this section Newgrange identifies that profitability analysis needs to be conducted over a full regulatory control period, and that to obtain comparisons with other sectors a wider array of metrics will likely be required.

The latter point is further emphasised in section 5 of the Report which considers the approach to profitability reporting for network industries in other jurisdictions, and considers reporting for other industries in Australia.

In this section of the Report Newgrange also notes that financial analysts and credit ratings agencies will usually report a range of metrics for network businesses.

## The proposed approach

Using the building blocks approach to revenue determination, the Newgrange Report argues that the second criterion proposed by McGrathNicol should not be applied.

Despite the best intent of policy makers and regulators, the development of revenue caps under a CPI-X approach is not simple. Profitability assessment needs to isolate from the regulated business those parts of its return that are regulated, and needs to address the complexity of that revenue determination approach.

The Report concludes that:

- it is good regulatory practice to report profits in a way that consumers and other stakeholders can understand and engage with;
- the AER does not currently collect the data needed for comprehensive profitability reporting through its regulatory information notice (RIN) process because (among other things) the allocation of corporate costs between regulated and unregulated lines of business needs to be explicitly accommodated;
- the AER can and should publish a range of metrics using the data collected, and that timing differences be accounted for; and

- the profitability measures could be further contextualised by being published alongside a range of other metrics such as reliability, service standards and asset utilisation.

# Response to questions

The Discussion Paper has posed six questions which have been answered indirectly above. For clarity, the responses are summarised in this section.

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?

   *As discussed above a wider range of profitability measures should be provided. In addition to the four measures identified by McGrathNicol, the IRR should be reported for comparison to New Zealand networks as should financing ratios.*

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 second criterion is inconsistent with the inherent complexity of the regulatory arrangements.*

3. Do you agree that the identified data is required to develop the preferred profitability measures?

   *Additional data is required that includes at least the data identified by the AER.*

4. If you consider other profitability measures should be reported, what data is required to support those measures?

   *We consider that the data for the additional measures will be captured in the approach to other data capture.*

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?

   *The same measures should be used for all regulated (network) businesses.*

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?

   *As discussed in the submission the profitability measures should be reported in conjunction with other outcome metrics.*

# Conclusion

Reporting of profitability is a regulatory oversight that needs to be rapidly rectified. Noting the timing issues instituting a reporting framework that relies only on the ability to obtain information through the issue of new RINs will result in a significant delay in obtaining meaningful reports.

The AER should move immediately to institute new RINs that capture all the information possibly required for the range of metrics that could be contemplated. It is more important to ensure the necessary data is captured than to achieve regulatory purity of only requesting data that will definitely be used.

However, recognising the importance of profitability reporting the network businesses should be asked to voluntarily provide the historic data for the last five years. Recognising the issues that have emerged with inconsistent responses to RINs in recent periods the AER should establish a small working group of networks and consumers to assist the AER in finalising the format of the notice.

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