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Mr Arek Gulbenkoglu
General Manager
Network Expenditure
Australian Energy Regulator

Via email: AERInquiry@aer.gov.au

Dear Arek

How the AER will assess the impact of capitalisation differences on our benchmarking – Submission to the Draft Guidance note

AusNet welcomes the opportunity to provide this submission to the Australian Energy Regulator's (**AER**) draft guidance note on the impact of capitalisation differences on the AER's benchmarking. We strongly support the AER addressing capitalisation differences that lead to distorted benchmarking outcomes, and we strongly support the position reached in the draft guidance note.

Benchmarking should be based on actual opex incurred consistent with the Cost Allocation Method (**CAM**) of the day, where exclusions are strictly limited to areas that are outside of networks' control, not-gameable, and do not reflect underlying efficiency e.g., Guaranteed Service Level (**GSLs**) payments. This is the first best approach that we outlined in our initial submission.

However, we support as a second best option, the AER's preferred approach of treating 100% of corporate overheads as opex for benchmarking purposes (option 5). The rest of our submission addresses the AER's implementation issues related to its preferred approach.

While it is positive that the AER is addressing the distortion caused by capitalisation differences, other material issues remain with the benchmarking models. These include the inherent differences in networks and their operating environments that are not comprehensively captured by the current suite of Operating Environment Factors (**OEFs**). We are currently undertaking some work on environmental factors that impact the costs of our network and will make a submission to the AER in February 2023. Another issue that we have raised consistently over the last few years is that GSLs, which have no bearing on the underlying efficiency of network businesses, are inappropriately included in benchmarking. We would welcome priority consideration of this outstanding issue.

The AER's benchmarking plays an important role in the regulatory determination process and its outcomes are given a lot of weight by stakeholders, including investors and consumer advocates. Given the numerous issues that have been raised with the current benchmarking models we strongly support a holistic review of the overall benchmarking approach to consider evidence-based changes to improve its accuracy.

Please do not hesitate to contact Angella Nhan on [redacted] about the submission.

Sincerely,

Charlotte Eddy
General Manager Regulation (Distribution)
AusNet Services

Cost Allocation Method

We support the AER's preferred approach to allocate 100% of corporate overheads to opex for benchmarking purposes (option 5). CAM-of-the-day is a superior approach compared to adopting a frozen CAM (2014 or 2022) because:

- benchmarking based on a frozen CAM will not be reflective of costs borne by customers, even if the 2022 CAM is adopted since CAMs have and will continue to evolve over time
- any potential changes to capitalisation policies that increase near-term cash flow will need to take into account its impact on benchmarking.

However, given the AER's preference to adopt a frozen CAM approach, we advocate for the use of the 2022 CAM instead of the alternative 2014 CAM. We consider that the 2022 CAM better reflects today's capex/opex practices, better aligns with opex borne by customers and reduces the material cost divergences that are currently observed between actual opex and benchmarked opex under the 2014 CAM approach.

Corporate overhead versus total overheads

We support the AER's preferred approach of treating corporate overheads (capitalised and expensed) as opex for benchmarking purposes. We consider this will improve comparability of results across DNSPs, is an economically sound adjustment and is a practical and simple change to implement.

However, for the reasons outlined below, we do not support the treatment of capitalised network overheads as opex:

- **Network overheads vary significantly as a result of operating model choices – which have no bearing or relationship with underlying business efficiency**.

  Network businesses that outsource their field delivery services are typically charged overheads as a direct cost by delivery partners as part of agreed rates. All else equal, these DNSPs incur higher direct costs (reported within Maintenance, Vegetation Management or direct Capex categories) and lower costs reported as network overheads. On the contrary, businesses that deliver field/network services in-house will incur these same costs but typically report some or all of these costs as part of network overheads (e.g., training, office expenses, depot costs, etc.). These network overheads are then subject to a business' capitalisation practices. As a result, network overhead costs can fluctuate significantly between DNSPs and also within DNSPs over time as a direct result of operating model decisions. This has no relationship with a business' underlying efficiency performance.

- **Corporate overhead costs are far less impacted by operating model choices, are clearly defined by the AER and there are limited reporting alternatives available. Therefore, such costs are more consistent over time and more comparable across businesses.**

  Unlike network overheads, the nature of corporate overhead costs means that they are less likely to be impacted by operating model decisions. For example, insourcing vs. outsourcing decisions in relation to a finance team will result in the costs being reported as corporate overheads irrespective of the operating model choice.

  Additionally, there is currently a clear definition of corporate overheads (inclusions/exclusions) and limited alternatives to reporting such costs anywhere in the Regulatory Information Notice other than within the 'Corporate Overheads' template. As such, the composition of corporate overheads is likely reasonably comparable across businesses.

  We understand concerns have been raised that network businesses will try to game the AER's approach by assigning overheads to 'network' rather than 'corporate' – however, for the above reasons we consider there is limited opportunity for this gaming to occur. We consider compliance with pre-existing AER definitions is sufficient to mitigate this risk.

Percentage of capitalised corporate overhead

We support the AER's preferred approach of allocating 100% of corporate overhead to the opex series for benchmarking purposes – this is a simple and transparent approach that also achieves comparability across network businesses. It is also aligns with the practice of several networks.

When and how to commence the opex series for benchmarking

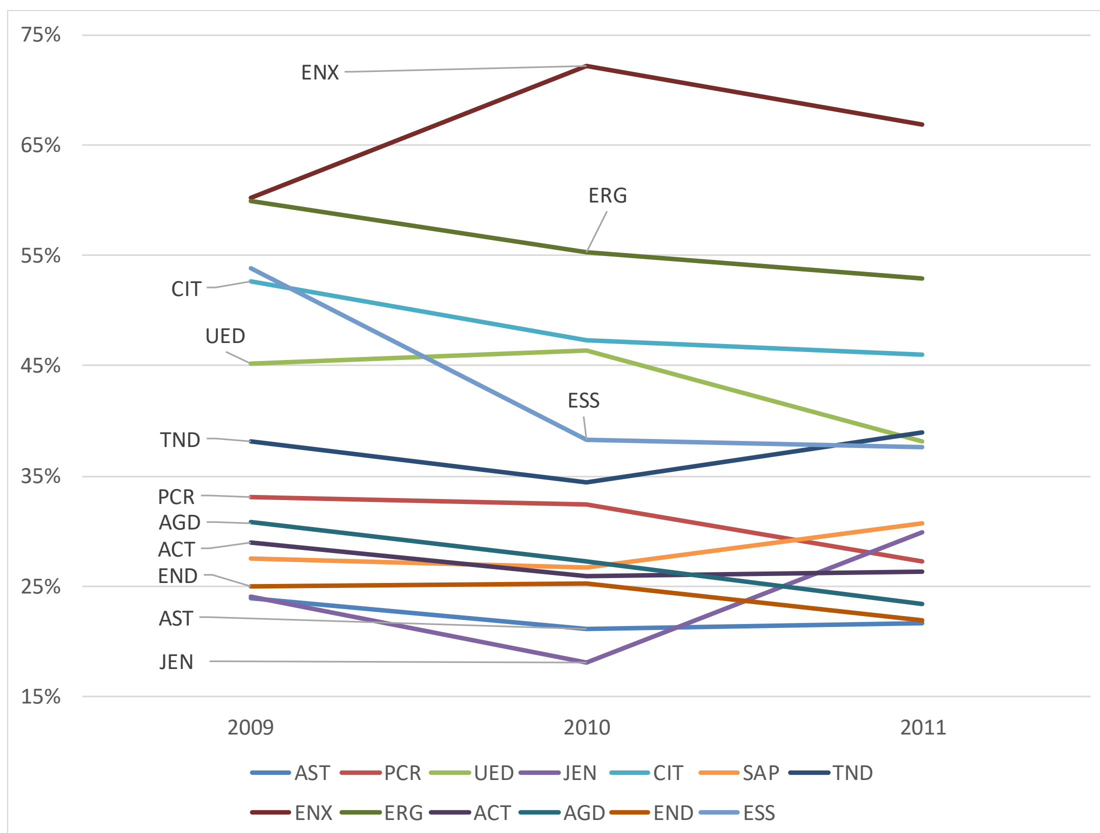
We support a time series that extends back to 2006 instead of 2009. However, as actual data does not exist over the 2006 to 2008 period, we support the AER's option of working with DNSPs to estimate corporate overhead costs for the missing period.

Corporate overhead costs for the missing period (2006 to 2008) can be estimated by referencing total opex and multiplying it by:

- the corporate overhead percentage as at 2009; or
- the average corporate overhead percent over the 2009 to 2011 period (3 years).

We support the former approach as the corporate overhead percentages from 2006 to 2008 are likely to be closer to the 2009 percentage, compared to the average over 2009 to 2011. The chart below shows that there was a general downward or upward trend across all businesses, which suggest that an estimation approach based on the average is less likely to be accurate compared to using the 2009 proportion.

Figure 1 Total corporate overheads (expensed and capitalised) as a percentage of total opex, 2009 to 2011



Source: RINs

Efficiency assessments in revenue determinations

We agree that there should be a consistency between the approach to opex benchmarking (which affects the AER's efficiency assessments) and how the opex base year is reported. This ensures that the AER's assessment of efficiency is based on a like-for-like comparison with the opex base year.

If the AER's final decision is to allocate 100% of corporate overheads to opex and apply a frozen 2022 CAM approach for benchmarking purposes, then the AER should undertake the following steps in the revenue determination process:

1. develop an alternative base year opex estimate inclusive of 100% of corporate overheads based on the network's frozen 2022 CAM
2. compare this to the network's proposed opex base year adjusted to include100% of corporate overheads, and back cast for the frozen 2022 CAM.

Both steps are practical to achieve.