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Via electronic lodgement: StandardSCSCapexModel@aer.gov.au

Dear Sebastian,

RE: AER standardised model for Standard Control Services capital expenditure

We welcome the opportunity to make this submission on the AER's standardised model for Standard Control Services (SCS) capital expenditure issues paper. A 'fit for purpose' standardised model will help increase regulatory certainty through a consistent treatment of capex data across determinations.

However, and as recognised by the AER, this model will not reflect all the unique circumstances that a specific business will face. Rather, it looks to standardise selected high level (non-project specific) aspects of the SCS capex model, such as overheads and CPI by having a default methodology that businesses can override if required.

We have undertaken a review of the preliminary SCS capex model and identified some key areas that should be addressed along with other stakeholder views before landing on an agreed approach. As outlined in Appendix 1 (see attached), these range from the operation of specific calculations within the model to broader questions concerning cost allocation methodology. For example:

- The AER appears to have assumed that both materials and contracted services will not be subject to real cost escalations moving forward. While we appreciate that this approach is consistent with recent AER decisions, the default position should be to allow for inputs of materials and contracted services cost escalations. This is an issue that DNSPs should be able to propose as part of the regulatory price determination process.
- We have identified a potential issue with the AER's proposed treatment of inflation and provide a suggested solution to this. Similarly, we have several questions with respect to the proposed treatment of capitalised overheads. Further consideration on those issues would be welcomed.

We have also identified the scope for the AER's model to include additional information that would help streamline the generation of other information that both we and the AER will use. We consider this can be achieved without unreasonably increasing the size or complexity of the AER's model. In doing so, this will help ensure the model is fit for purpose.

We look forward to working with the AER on this issue, including through any workshops that may be held. If you have any questions regarding this submission, please contact Steven Martin by email on [redacted]

Yours sincerely

Charlotte Eddy
Manager Economic Regulation
AusNet

Appendix 1

Review of AER preliminary standardised SCS capex model

1. Model Input / Escalations

The response below relates to the information presented in 'Input| Escalations' sheet.

Under 'section 7. Inflation table setup', we agree with allowing the user to select options for Base year inputs to be in either December (middle of year terms) or June (end of year terms). However, we have detected an error in the construction of the inflation index – as presented in 'section 8. Inflation'.

In the scenario where 'December' (mid-year dollars) is selected as the Base year for inputs, the AER's draft construction of the inflation index (as calculated at row 18) does not properly apply the expected level of escalation to take mid-year base inputs to $Jun 2021 terms[1] (before real labour cost escalations). This, in turn, results in the calculated value of escalated direct costs being understated in subsequent sheets within this model.

This can be illustrated if we consider our recently submitted and approved 'in-house' capex model[2] as part of the 2021-26 Electricity Distribution Price Review (EDPR) for AusNet Electricity Services.

Figure 1 – Inflation index (Mid-year $2018 to Mid-year Nominal)

Table 1 - CPI Indexes	Jun-15	Jun-16	Jun-17	Jun-18	Jun-19	Jun-20
	Actual	Actual	Actual	Actual	Actual	Actual
Applies to year	**2016**	**2017**	**2018**	**2019**	**2020**	***Jan21-Jun21***
CPI - 8 cities - Jun Qtr, 1yr lagged	107.5	108.6	110.7	113.0	114.8	116.2
CPI movement - 8 Capital Cities	1.51%	1.02%	1.93%	2.08%	1.59%	1.22%
$2015 to nominal	1.015	1.025	1.045	1.067	1.084	1.097
Mid $2018 to Mid Year Nominal			1.000	1.0201	1.0388	1.0598

Source: AusNet

The inflation index highlighted in Figure 1 above uses 1-year lagged actual inflation consistent with the standard approach.

In this scenario, where we want to convert mid-year $2018 (base inputs) to mid-year nominal terms, the construction of the inflation index references annual CPI movement on a 2-year rolling basis. That is, a half year of inflation from year t-1 multiplied by a half year of inflation from year t rolling into the cumulative inflation index. We set out the approach below that calculates the required annual escalation factors up to and including Jun-21:

Escalation factor (Ef) for year 2019:

1.000 (Ef t-1) * (1+1.93%)^0.5 * (1+2.08%)^0.5 = 1.0201

These formula precedents are highlighted below in Figure 2.

[1] When we set the first year of the forecast regulatory control period to '2021-22' in the preliminary SCS capex model.

[2] Available at: AER - Final Decision - AusNet Services distribution determination- 2021–26 - Capex model - April 2021.

Figure 2 – Inflation index (Formula precedents)

Table 1 - CPI Indexes	Jun-15	Jun-16	Jun-17	Jun-18	Jun-19	Jun-20
	Actual	Actual	Actual	Actual	Actual	Actual
Applies to year	**2016**	**2017**	**2018**	**2019**	**2020**	***Jan21-Jun21***
CPI - 8 cities - Jun Qtr, 1yr lagged	107.5	108.6	110.7	113.0	114.8	116.2
CPI movement - 8 Capital Cities	1.51%	1.02%	1.93%	2.08%	1.59%	1.22%
$2015 to nominal	1.015	1.025	1.045	1.067	1.084	1.097
Mid $2018 to Mid Year Nominal			1.000	1.0201	1.0388	1.0598

Source: AusNet

From there we can calculate the escalation factor for year 2020 as follows:

1.0201 (Ef t-1) * (1+2.08%)^0.5 * (1+1.59%)^0.5 = 1.0388

And finally, we can calculate the escalation factor for year H12021 as follows:

1.0388 (Ef t-1) * (1+1.59%)^0.5 * (1+1.22%) = 1.0598

Note, the H12021 CPI value of 1.22% is a half year actual inflation from Jun-19 to Dec-19.

When we attempted to simulate the same approach in the standardised SCS model, by selecting December (mid-year) as the base year for inputs and then entering the relevant CPI values, we found this did not produce an expected escalation factor consistent with the approach set out above.

We have also identified a minor issue for the June half year inflation value (cell J16) that feeds into the cumulative inflation index. A calculation is not required if actual six months inflation (1 year lagged) is known/available at the time from published ABS data. This was the case in the RAB roll forward for the Victorian distributors in the 2021-26 EDPR. We recommend that this half year inflation be an input rather than a calculation to avoid likely imprecisions in the cumulative inflation index, or at least provide an option to enter this value that overrides the default calculation.

A potential solution to address the overall approach in the standardised SCS model is to insert a new row that follows the approach we have set out above (as per our in-house capex model). We note that other Victorian distributors have applied a similar approach in their in-house capex models as part of the 2021-26 EDPR process.

2. Real price escalation

As noted in the AER issues paper, the standardised SCS model allows for labour cost escalations but does not allow for materials or contracted services cost escalations. While we acknowledge that outcome is consistent with recent AER decisions, we consider that this position shouldn't dictate the standard inputs available in the model. A better approach would be to provide network services providers flexibility to propose real cost escalation in future resets, depending on the circumstances at that time.

We, therefore, suggest that sufficient functionality is built into the model to allow for these options to be proposed as part of the EDPR process. The merits of this can then be assessed by the AER as part of the determination process.

For clarity, we would propose a similar approach if the AER were to consider establishing a standardised PTS capex model for transmission services providers as part of standardising the transmission revenue reset process.

3. Capitalised overheads

We have identified two areas of concern with the AER's approach to capitalised overheads:

- the methodology for allocating overheads to projects; and
- whether overheads are appropriately allocated to direct costs attracting overheads (which in our case excludes gifted assets).

The AER issues paper describes the methodology for forecasting the annual amount of capitalised overheads and states that "capitalised overheads are then allocated to project codes that the distributor has identified as attracting overheads, on a direct project cost to total direct capex basis."[3] From this, it is unclear whether the amount of overheads allocated to individual projects will be linked to an overheads pool that distinguishes between network and non-network categories.

Under our Cost Allocation Methodology (CAM), we apply overheads on a proportional basis with total direct capex costs and then determine an annualised allocation rate of overheads for both network and non-network IT categories. In our regulatory submission (in-house) models for electricity distribution, the network category encompasses augmentation, replacement, and connections.

To better understand the AER's proposed approach we would, therefore, appreciate if it can clarify:

- If the AER intends to expand the approach to forecasting capitalised overheads in the standardised SCS model beyond the existing RIN categories of network and corporate overheads? Specifically, by allowing for input of historical network and non-network IT overheads to drive the forecast of these overhead pools in the model, and/or allow for direct input of forecast capitalised overheads under these categories.

- For transparency reasons, if the AER could consider including tables which show the applicable overhead rates by category / purpose? This would be consistent with our general modelling approach in recent price determinations and contingent project applications, thus allowing us to also populate several reset RIN capex tables.
- If the calculated overhead rates will apply to total direct costs that are subject to overheads (excluding gifted assets)? Based on our initial review of the tables and rates contained in 'Calc| Overheads Allocation' sheet it appears this may be optional.

4. Customer contributions

The AER issues paper notes that capital contributions are allocated to projects in the standardised SCS model based on the *percentage of direct costs* input by a business. However, this approach differs from our current modelling approach for new customer connections and the underlying composition of customer contributions.

We capture our historical capital contributions by category in our in-house connections capex model and calculate the average contribution rate from customers by taking total contributions over total gross capex (including overheads). Noting that each individual customer contribution inherently includes a portion of capitalised overheads (as this is a relevant cost in the incremental revenue less incremental costs test).

To ensure that capital contributions are a product of total costs, including overheads, we therefore propose that the calculation of customer contributions in the standardised SCS model comes after overhead allocations. Practically, this means altering the model inputs to allow for the percentage of total costs rather than direct costs.

5. Outputs

We would prefer more flexibility in defining the mapping categories that ultimately determines the suite of outputs contained in the standardised SCS model.

[3] AER issues paper - standardised SCS capex model - August 2021_0, p.6.

Currently, the mapping categories are confined to 'AER categories' and 'RIN categories', however, there may be merit in considering adding extra categories and input column(s) to allow for:

- Population of additional output tables in the standardised SCS model that can generate inputs for other RIN tables (in addition to the summary RIN capex drivers); and
- Additional output tables which align with individual DNSP's own internal cost drivers. This can be made optional, but we see this as a useful tool to allow us to track expenditures according to our internal cost drivers which do not necessarily align with AER categories or RIN categories. Otherwise, there is potential for DNSP's to continue to utilise their in-house capex models alongside the standardised SCS model which is neither the intended nor most efficient approach.

These changes could be implemented in the standardised SCS model without unreasonably increasing the size or complexity. Some examples of these types of outputs are available in our in-house capex model submitted in the recent 2021-26 EDPR. We are happy to discuss this aspect further with the AER as part of the next phase of this review.

6. Other considerations

We note the high-level layout of the preliminary standardised SCS model presented in the AER issues paper.[4]

The AER could consider incorporating a process map within the model itself to provide greater transparency of the data process flows starting from model inputs through to calculations and final outputs. This would be an example of modelling best practice, subject to any further plans the AER has in relation to publishing a model handbook that would set this out in further detail.

[4] AER issues paper - standardised SCS capex model - August 2021_0, p.5.