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18 February 2022

Sebastian Roberts
General Manager, Network Expenditure
Australian Energy Regulator (AER)
GPO Box 520
Melbourne VIC 3001

Via email: AERInquiry@aer.gov.au

Dear Sebastian,

RE: Submission on the impact of capitalisation on the AER's benchmarking

AusNet welcomes the opportunity to participate in the AER's consultation on its approach to assessing the impact of differences in capitalisation on benchmarking.

AusNet has long supported the application of benchmarking in the regulatory framework. However, over the last few years we have become increasingly concerned about the accuracy of the AER's benchmarking approach, for reasons including:

- Material opex incurred by some businesses (up to 30%) is excluded from benchmarking, to apply historical capitalisation policies to current opex.
- The current benchmarking approach does not appropriately reflect inherent differences in networks and their operating environments. The OEF framework needs further development.
- Guaranteed Service Levels (GSL) opex and pass-through opex which have no bearing on the underlying efficiency of the network should not be included in benchmarking.

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. We strongly support a holistic review of the overall benchmarking approach to consider evidence-based changes to improve its accuracy.

Addressing capitalisation differences

Capex-opex trade-offs

The AER's opex benchmarking is given more weight in regulatory decision-making processes than its capital, or overall, productivity benchmarking. All else equal, this can lead to an incentive to adopt capital, rather than opex solutions.

Notwithstanding this, we do not support a benchmarking adjustment that seeks to adjust for all capex/opex trade-offs. Networks make numerous operational decisions that involve trading off capex and opex solutions. This may include investing in ICT systems to automate processes versus employing more staff; or maintaining versus replacing an asset for example. Adjusting opex benchmarking for the outcomes of these decisions would remove the impact of potential inefficiencies. This is not desirable for customers, given the higher impact on price of opex compared to capex, and is also not required for meaningful benchmarking as networks all face numerous decisions of this nature with potentially similar relative costs.

However, there is a case to exclude specific capex/opex trade-offs from the benchmarking if they are both material and relate to the specific circumstances of a network. These could include:

- Non-network solutions (e.g., demand management, network support or stand-alone power systems (SAPS)), as networks with growth areas (for demand management and network support) or rural networks (SAPS) have more opportunity to adopt these solutions and benchmarking should not discourage lowest cost solutions being adopted; and
- ICT cloud and Software as a Service – this expenditure can be lumpy and the timing of material opex being incurred will depend on the stage of the lifecycle of networks' ICT systems.

As these costs may be material and depend on network-specific factors, we have proposed removing them from opex benchmarking. This is similar with the approach taken for leases – AusNet capitalises leases but they are included in opex for benchmarking purposes, to align with the treatment for other networks.

Capitalisation policies

Overheads (both corporate and network) represent a very material part of opex. The capitalisation applied to overheads matters for benchmarking and the exclusion of opex due to old capitalisation policies has been the focus of stakeholder submissions to the AER.

As set out below, as a starting point the AER should use current capitalisation policies for its benchmarking. Any adjustment to account for capitalisation policy differences should be supported by evidence that the adjustment reflects these differences.

Changes proposed to address capitalisation differences

Any changes to the benchmarking should be transparent, consistent across all DNSPs, well-understood by stakeholders and produce results that are intuitive. There is a need to sense check the results rather than rely on hypothesis and modelling results alone. This will help to avoid undetected errors in benchmarking outcomes as has been experienced recently with the change to input output weightings by Economic Insights.

The preferred approach set out in the paper does not meet these objectives. Specifically:

- It is not supported by evidence. The ratios the AER intends to use for its OEF adjustment for capitalisation do not strongly correlate with network's capitalisation policy differences, the most material difference in capitalisation practices across networks.
- One of these ratios (opex to totex) is correlated with company size – therefore applying this ratio to derive an OEF would be an adjustment for scale (already dealt with by the benchmarking), rather than capitalisation differences.
- The use of an OEF rather than a direct adjustment to benchmarking inputs introduces complexity and is also less accurate than amending input data to adjust for differences.

We recognise the AER's preference is to apply a high-level approach rather than one that relies on a more detailed consideration of capitalisation practices. However, unless the adjustment is demonstrated to improve the accuracy of the benchmarking, it should not be applied.

Preferred solution

We suggest the following approach:

1. Benchmark based on actual opex incurred under the capitalisation policy in place in each given year. This addresses the current inconsistency whereby some businesses' opex is unjustifiably excluded from benchmarking calculations.

2. Apply a uniform capitalisation treatment to specific capex/opex trade-offs i.e., Software as a Service (SaaS), IT cloud solutions and non-network solutions could be treated as capex for benchmarking purposes, and leases treated as opex. This normalises for opex/capex trade-offs that can be material and are specific to a networks' circumstances.

3. If there is to be a normalisation for capitalisation policy differences, then actual opex should be normalised for differences in capitalised corporate overheads by applying a common ratio. This addresses a material source of capitalisation differences between businesses. This approach should be monitored for effectiveness over time.

The attachment contains detailed responses to the issues raised. Please contact [redacted] ([redacted]) with any questions in relation to this submission.

Yours sincerely

Charlotte Eddy
General Manager, Regulatory Strategy and Policy
AusNet Services

Attachment 1

AUSNET: RESPONSE TO BENCHMARKING CAPITALISATION APPROACH ISSUES PAPER

AusNet welcomes the AER's consultation on the approach to capitalisation that should be adopted in its benchmarking. We observe that while the issue of capitalisation has been debated in Jemena's recent distribution determination process, this consultation paper is the first attempt at a consolidated and wide-reaching stakeholder consultation on this topic.

Any adjustments or changes to the current benchmarking process must be proven to increase the accuracy of the benchmarking results, otherwise it will increase the complexity of benchmarking to no benefit.

Our response to the questions raised in the consultation paper are below.

1 TIMING AND CONSULTATION

1.1 Do you have any comments on our planned process for consultation, including on the timelines?

As this is a complex topic, AusNet would welcome a 2-week extension on the draft guidance submissions period. That is, the period between the publication of the draft guidance (mid-May 2022) and submission on the draft guidance (mid-June 2022) should be increased from 4 weeks to 6 weeks.

1.2 Do you have any views at this stage on whether group workshop sessions or one-on-one meetings would be preferable?

We support both group sessions and one-on-one meetings. Group workshops would allow stakeholders to understand each other's insights and perspectives.

2 CAPITALISATION PRACTICES

2.1 Do you agree with the proposed definition of capitalisation practices? Do you consider this is capturing the range of capitalisation practices that (at least in theory) could be influencing the comparability of the benchmarking results? If you consider the range is too narrow or too broad, please provide the definition you consider is appropriate and your reasoning and supporting evidence.

The AER has defined 'capitalisation practices' to encompass two broad types of capitalisation practices undertaken by DNSPs:

- Capitalisation policies i.e., a business's policy and/or specific method of reporting/classification of expenditure as opex or capital expenditure (capex), (e.g., expensing/capitalising overheads); and
- Opex / capital trade-offs, i.e., a business's utilisation of opex versus capital inputs e.g., the choice for non-network Information Communication and Technology (ICT) between the use of cloud computing (opex) versus in-house equipment (capital inputs); demand management (opex) versus augmenting existing circuit length or transformer capacity (capital inputs).

We agree with the AER's capitalisation practices definition, but consider it is too broad for the purposes of benchmarking adjustments. Not all opex/capex trade-offs should be adjusted for in the benchmarking.

As explained in our cover note, only capex/opex trade-offs that are both material and relate to the specific circumstances of a network should be excluded from the benchmarking. These include:

- Non-network solutions (e.g., demand management, network support or stand-alone power systems (SAPS)), as networks with growth areas (for demand management and network support) or rural networks (SAPS) have more opportunity to adopt these solutions and benchmarking should not discourage lowest cost solutions being adopted; and
- ICT cloud and Software as a Service – this expenditure can be lumpy and the timing of material opex being incurred will depend on the stage of the lifecycle of networks' ICT systems.

This opex should be removed from the opex input, therefore an OEF is not required. This is similar to the approach taken for leases – AusNet capitalises leases but they are included in opex for benchmarking purposes, to align with the treatment for other networks.

We note that if equivalent weight were placed on the capital or overall productivity benchmarking, in the regulatory determination process, as is given to the opex benchmarking, the adjustment suggested above would not be required.

2.2 Do you consider that our focus on capitalisation practice differences instead of cost allocation differences more broadly is appropriate? If not, please provide your reasoning and supporting evidence.

We agree that the focus should be on capitalisation practice differences instead of cost allocation differences. We are not aware of any stakeholder feedback raising a concern about the allocation of costs between Alternative Control Services and Standard Control Services (as an example). Whilst capitalised overheads are one of the outputs of the Cost Allocation Methodology (CAM), differences with respect to the treatment of overheads for benchmarking purposes can be resolved without reviewing the CAMs.

3 RATIOS

3.1 What are your views on the use of the three ratios set out above to measure capitalisation differences between DNSPs?

In the consultation paper, the AER presents several options to adjust for capitalisation differences, with a focus on the approach applied in Jemena's recent determination, which are the following high-level ratios:

- Opex to totex;
- Opex to total cost; and
- Opex to total inputs.

We oppose using these ratios to measure capitalisation differences between DNSPs due to the lack of evidence to support a correlation between these ratios and differences in capitalisation, as explained below.

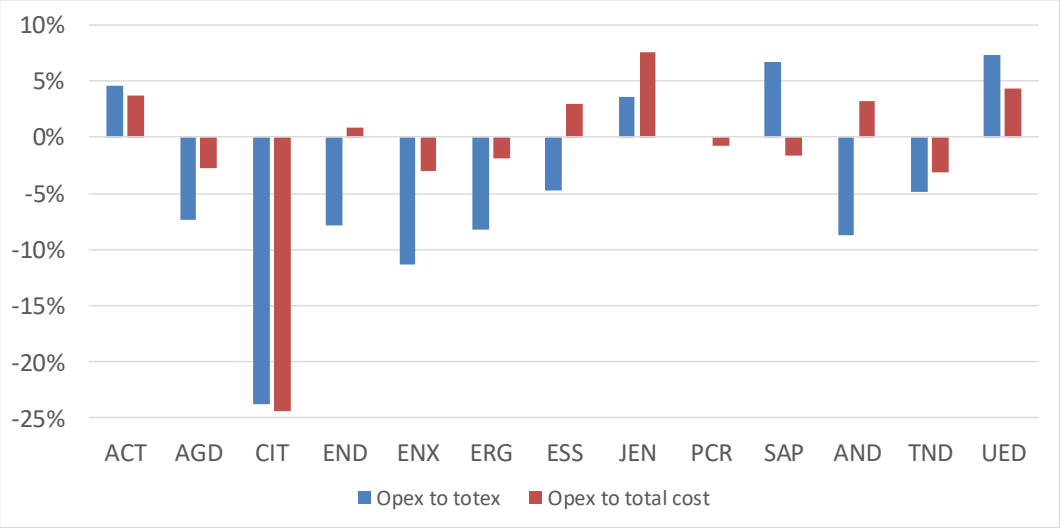
The Ratios Present Contradictory Results

For some networks, difference ratios imply different conclusions about their level of capitalisation relative to comparator averages.

In the chart below, we have plotted the change in efficiency scores by benchmarking using comparator averages for both the opex to totex ratio and the opex to total cost ratio. Different ratios give opposing results for Endeavour Energy, Essential Energy, SA Power and AusNet. For example, AusNet is materially above the comparator average for the opex to total cost ratio, but materially below for the opex to totex ratio. This means that some networks will get materially different adjustments to their efficiency scores depending on the ratio considered, and different combinations of these ratios will drive very different results.

The contradiction makes it difficult to understand what the three ratios represent, alone and in combination. They cannot all represent AusNet's relative level of capitalisation. We do not know how to interpret these results – the ratios combined provide no useful information as to whether AusNet's capitalisation practices result in more or less opex than the industry average.

Figure 1 AER's change in efficiency scores by benchmarking using comparator averages



Source: AER, AusNet

The Ratios are Uncorrelated to Capitalisation

We have conducted in-depth analysis that demonstrates these ratios are unrelated to capitalisation differences. Therefore, they are inappropriate as measures to correct for capitalisation differences.

For a ratio to be a good proxy for capitalisation differences, it needs to be highly correlated to capitalised corporate overhead percentages given it represents a large proportion of opex[1] and the variation in expensed corporate overhead between networks.

In the charts below, we have reproduced the three ratios using actual opex[2] and plotted them against the following two capitalisation ratios:

- Capitalised corporate overhead as a proportion of total corporate overhead; and

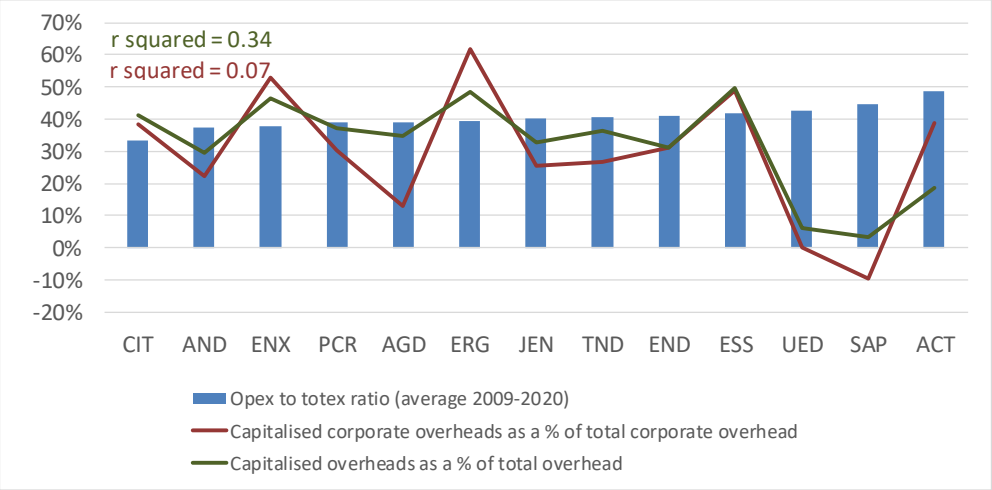
[1] See section 'Materiality of Overheads'

[2] We have reproduced the ratios using actual opex from the category analysis RINs, instead of the opex benchmarking data that the AER used in its consultation paper. Since our preferred approach is to benchmark based on actual data (see section 3.4), it therefore follows that our analysis of the appropriateness of the ratios are also based on actual opex. However, we have also reproduced the ratios using opex benchmarking data (2009 to 2020) and found the r-squared values to be low (0 to 0.43), which means the AER's ratios based on benchmarked opex also do not correlate to capitalisation rates.

- Capitalised overhead as a proportion of total overhead (where overhead is the sum of network and corporate overheads).

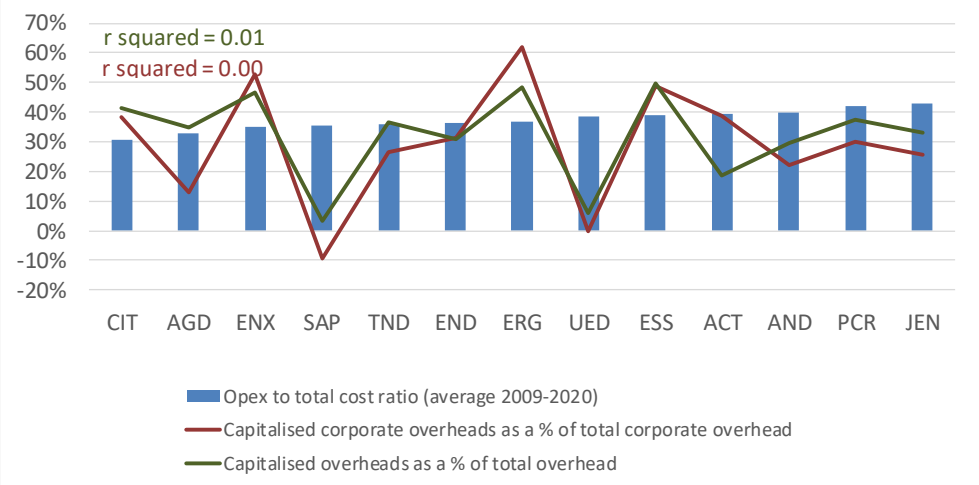
If the ratios are correlated to the capitalisation ratios, then the r-squared would be close to 1. Instead, our results show that there is no correlation (low r-squared values varying from 0.0 to 0.34) and that they are not inversely correlated.

Figure 2 Opex to totex ratio vs. capitalisation rates



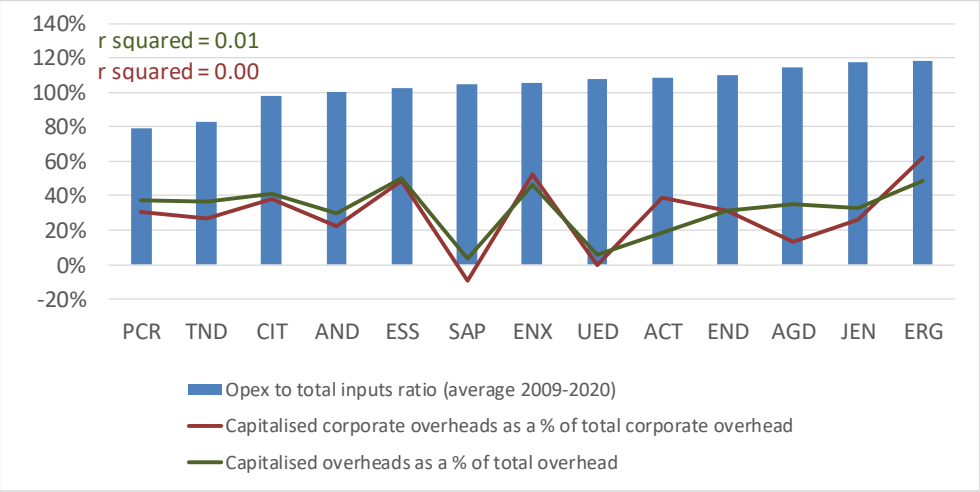
Source: AusNet

Figure 3 Opex to total cost ratio vs. capitalisation rates



Source: AusNet

Figure 4 Opex to total inputs ratio vs. capitalisation rates



Source: AusNet

Regarding the opex to totex ratio, we note that the network with the highest opex/ totex ratio (ACT) has the same capitalised corporate overhead rate as the network with the lowest opex/totex ratio (CIT), further demonstrating the lack of relationship.

This is compelling evidence to reject the use of these ratios in adjusting for capitalisation differences.

Materiality of Overheads

Capitalisation of overheads is the most material source of capitalisation differences between businesses. If an adjustment is required to actual opex to address capitalisation differences, the AER should focus on identifying an accurate approach to address this issue (in addition to adjusting for specific, material opex/capex trade-offs); and in particular differences in the corporate overheads given the greater comparability of costs across networks for corporate, rather than network overheads. Whether certain overhead and management activities are reported as network overheads or direct costs can be significantly impacted by outsourcing arrangements, limiting the comparability across networks.

In Table 1 below, we have summarised the value and proportion of corporate and total overheads (corporate and network) that have been expensed as opex. We observe that there are large differences between businesses':

- Expensed corporate overhead as a proportion of opex varies from 14% to 40%; and
- Expensed total overhead (sum of network and corporate overheads) as a proportion of opex varies from 40% to 66%.

As they represent a large component of opex, any capitalisation differences within the corporate overhead and overhead areas can represent a large component of capitalisation differences between businesses.

Table 1 2009 to 2020 averages (thousands)[3]

	Actual opex	Expensing of corporate overhead	Expensing of corporate overhead as a % of opex	Expensing of overhead (network + corporate)	Expensing of overhead as a % of opex
ENX	389,236	110,597	28%	251,059	65%
AGD	521,465	106,907	21%	300,886	58%
ERG	396,607	70,334	18%	231,852	58%
ESS	382,263	70,305	18%	153,119	40%

[3] Column 3 (the % column) = column 2 (average expensed corporate overhead) divided by column 1 (average actual opex). An alternative is to calculate the percentages for each year and then take the average.

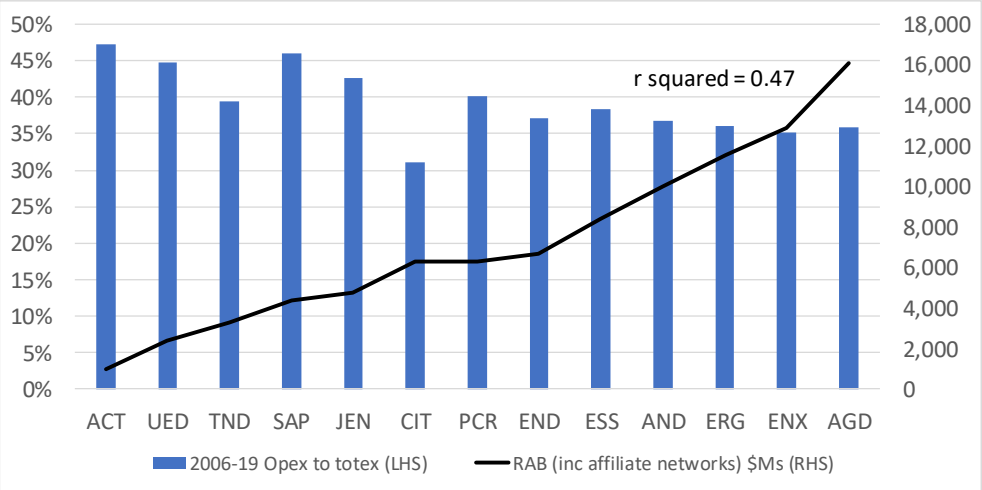
END	271,697	67,783	25%	151,863	56%
SAP	219,078	58,610	27%	132,728	61%
PCR	182,755	45,846	25%	85,386	47%
AST	186,160	25,668	14%	79,455	43%
TND	79,031	18,247	23%	46,933	59%
JEN	74,461	22,732	31%	49,143	66%
UED	116,712	46,674	40%	65,608	56%
CIT	60,132	18,228	30%	36,354	60%
ACT	57,128	10,869	19%	37,427	66%

Source: AusNet

Opex to totex better correlates with size of the business

Figure 5 below shows that the opex/totex ratio applied by the AER[4] is correlated to firm size, proxied by RAB size including affiliate networks. We would expect this result given economies of scale. Smaller firms have a higher proportion of fixed opex costs, and therefore higher opex as a percentage of total costs, compared to larger firms. Therefore smaller firms such as Evoenergy and United Energy would have higher opex to totex ratios compared to larger firms such as Energex and Ausgrid. We note that Citipower is an outlier as the AER has previously acknowledged.

Figure 5 Opex to totex cost ratio vs. company size



Source: AusNet; AER 2021 Network Performance Report data and Jemena determination
Note: Affiliate networks include TasNetworks transmission and distribution; Jemena electricity and gas distribution; AusNet Services transmission, distribution, and gas; Powercor and Citipower combined. The formation of Energy Queensland and United Energy's merger with Citipower and Powercor are assumed not to have occurred given they occurred late in the 2006-19 period.

The opex/total cost and opex/total inputs ratios are not correlated with firm size.

3.2 What are your views about the advantages and disadvantages of each of the opex/capital ratios?

Opex to totex ratio

The primary advantage of the opex to totex ratio is the simplicity of the calculation. However, it is our view that the disadvantages below far outweigh this advantage.

Disadvantages of the opex to totex ratio include:

- This ratio is unrelated to capitalisation differences as demonstrated in section 3.1.

[4] This analysis adopts the opex/totex ratios applied in the Jemena determination

- This ratio better correlates with the size of the business as demonstrated in section 3.1. Therefore, any adjustment performed using the ratio is predominately an adjustment for company scale, rather than for differences in capitalisation.
- We do not believe this ratio provides any information about AusNet's relative capitalisation position. Our opex to totex ratio over 2009-20 is lower than other networks, despite our expensed overheads (a material proportion of opex) being a relatively higher proportion than compared to the industry average; for example, we expense 77% of corporate overheads compared to the industry average of 71%, and we expense 71% of total overheads compared to the industry average of 68%.
- This ratio is impacted by state-specific investment requirements unrelated to efficiency, limiting comparability between States. The increased safety obligations in Victoria following the 2009 bushfires means that we have ongoing prescriptive obligations that require spending additional capex compared to distribution businesses in other states. This disproportionally increases our capex, increasing the denominator in the ratio.

Opex to total cost ratio

Similar to the opex to totex ratio, the primary advantage of the opex to total cost ratio relates to its simplicity. This ratio will be less volatile than the opex/totex ratio as it is less impacted by lumpy capex spend over short periods of time.

While this ratio is unrelated to capitalisation differences (see section 3.1), for AusNet the outcome is in line with what we expect given our relatively high expensing of overheads compared to the industry average. However, we note that the demonstrated lack of relationship between this ratio and overhead capitalisation rates implies this result could be coincidence.

Again, the disadvantages of applying this ratio far outweigh the advantages.

Disadvantage of the opex to total cost ratio:

- This ratio is unrelated to capitalisation differences as demonstrated in section 3.1.
- It is not clear that historic capex investment or post-privatisation RAB balances are relevant to networks' relative capitalisation policies and practices today.

Opex to total inputs ratio

Similar to the opex to totex ratio, the primary advantage of the opex to total inputs ratio relates to its simplicity. Yet, the fact that it is unrelated to capitalisation differences as demonstrated in section 3.1, makes it an unsuitable ratio.

3.3 Do you consider that one or more of these ratios is more appropriate?

For the reasons outlined earlier, we do not consider any one of the AER's proposed ratios to be appropriate.

3.4 Do you have any other suggestions as to how we can review and measure the differences in capitalisation practices between DNSPs?

We have proposed a three-step process below. This does not require complex OEFs to be calculated and applied, and directly adjusts for known differences in capitalisation.

Step 1. Benchmark based on actual opex incurred under the capitalisation policy in place in each given year. This addresses the current inconsistency whereby some businesses' opex is unjustifiably excluded from benchmarking calculations.

Other advantages include:

- Costs are based on what customers currently fund as capex and opex which is more accurate;
- Benchmarking based on past policies is not reflective of costs borne by customers and is increasingly divergent from approved allowances; and

- Businesses need to consider the impact on benchmarking if they are to change policies that increase near-term cash flow, increasing prices.

2. Apply a uniform capitalisation treatment to specific capex/opex trade-offs i.e., Software as a Service (SaaS), IT cloud solutions and non-network solutions could be treated as capex for benchmarking purposes, and leases treated as opex. This normalises for opex/capex trade-offs that can be material and are specific to a networks' circumstances.

The advantages of applying a common capitalisation treatment to these discrete areas are:

- Comparability of the benchmarking is preserved.
- This approach is both transparent and simple – it is a direct adjustment for a known issue and can be easily understood by stakeholders. These specific items could be added to one of the RIN tables and audited.
- Mirrors the existing treatment of leases, which are treated as opex for benchmarking despite some networks capitalising these.
- This process is flexible and can be adapted to other emerging material opex/capex trade-off and/or continual changes in capitalisation policies.
- This approach does not impede the robustness or validity of benchmarking.
- This would not add significant additional reporting burden as these categories are discrete and easy to identify.

3. If there is to be a normalisation for capitalisation policy differences, then actual opex should be normalised for differences in capitalised corporate overheads by applying a common ratio. This addresses a material source of capitalisation differences between businesses. This approach should be monitored for effectiveness over time.

3.5 Do you have any views about the proposed framework for using these ratios to determine that the differences as a result of capitalisation are material i.e. where the difference in capitalisation leads to an opex difference that is greater than 0.5 per cent?

This assessment is not required under our proposed approach.

4 IMPACT OF CAPITALISATION PRACTICES

4.1 What are your views on the approaches presented in this section for determining the impact of capitalisation differences on the benchmarking results?

Figure 5 of the AER's consultation paper shows that 11 of the 13 DNSPs have an improved efficiency score of between 7 and 15 percentage points when benchmarking is based on current capitalisation policies compared to the 2014 capitalisation policies on which the AER currently undertakes benchmarking. It is not clear whether this analysis incorporated the results of the opex to capital ratio departures, or simply held all variables constant, save for the capitalisation policies.

Table 2 of the AER's consultation paper shows the change in efficiency scores by benchmarking using comparator-average for both the opex/totex and opex/total cost ratios. It is not clear whether these changes in efficiency scores were calculated with respect to the 2014 capitalisation policies or the current capitalisation policies.

It would be worthwhile to combine the two analysis above, i.e., show the change in efficiency scores when benchmarking is based on current capitalisation policies that incorporates the results of the opex to capital ratio departures. This would allow a more holistic understanding of the ratios and allow critical feedback on the usefulness of the ratios as OEF.

4.2 Do you consider there are other approaches that could be used to determine the impact of capitalisation differences on the benchmarking results?

An alternative to our preferred approach and the approaches outlined by the AER is a variation of option 5 (Benchmarking with a fixed proportion of total overheads) of the AER's options analysis.

That is, use the current benchmarking approach as the starting point (based on the 2014 CAMs), and then normalise the results for differences in capitalised corporate overhead rates. This addresses the issue of capitalisation differences in corporate overhead and is a transparent and simple approach.

This would be a superior solution to the AER's proposed ratios because it addresses a discrete issue and does not confuse and adjust for other factors such as economies of scale. It is a far superior approach in terms of accuracy, reliability and validity, particularly given the lack of evidence in support of the AER's approach.

5 POSSIBLE OPTIONS FOR ADDRESSING MATERIAL DIFFERENCES

5.1 What are your views about the assessment principles we have used to examine these options? Are there other factors that you consider we should take into account as a part of our assessment?

The AER adopted the assessment principles set out in their Expenditure Forecast Assessment Guidelines, being:

- Validity and fitness for purpose
    - reasonably reflects the material differences, e.g., in capitalisation between DNSPs, and takes into account any issues with the estimation of these differences
    - does not create any perverse incentives for businesses to change their capitalisation policies or opex / capex mix in response to its benchmarking results
    - the extent to which it is consistent with our other assessment approaches e.g. for capex.
- Accuracy and reliability: reflects/takes into account the most recent data and practices, and produces unbiased and consistent results
- Robustness: remains valid under different assumptions and conditions and is stable over time.
- Transparency: is based on a transparent methodology that can be replicated by stakeholders.
- Parsimony: we will typically prefer a simpler technique (or one with fewer free parameters) over more complex techniques.

We agree with the AER's assessment principles listed above. However, the AER's proposed ratios do not satisfy many of these assessment criteria as we have discussed below.

We note that the AER summarised their initial assessment of the options (Table 3) and concluded that the OEF adjustment scored 50% or 75% against each assessment criteria, which is far above the scores for the other options. The rationale for these rankings is not explained. We are keen to understand the factors that underpin Table 3, in particular, how the OEF adjustment scored 75% and 50% for the validity/fitness for purpose and accuracy/reliability criteria, respectively.

5.2 What are your views about the options we have identified for addressing the impact of material capitalisation differences on our benchmarking? Are there other options that should be considered?

The AER has identified the following possible options for addressing material differences:

1. Applying an OEF adjustment for capitalisation using opex/capital ratios
2. Adding an explanatory variable to the econometric benchmarking models that directly captures capitalisation practices
3. Benchmarking based on DNSP's current capitalisation policies
4. Obtaining efficiency scores based on a common opex/capital ratio applied to all businesses

5. Benchmarking based on a fixed proportion of overheads
6. Introducing a common capitalisation policy for benchmarking.

We have explained our views of these options below.

Applying an OEF adjustment for capitalisation using opex/capital ratios

As explained above, we oppose the application of the opex/capital ratios as there is no evidence to support this approach.

In particular:

- It is not valid and fit for purpose. The consultation paper states this approach is valid and fit for purpose because the data is available to implement an OEF. We disagree that the availability of data means it is valid and fit for purpose.
- It is not accurate and reliable. This is demonstrated by the lack of correlation with capitalisation differences. We question why this option scored 50% on accuracy and reliability.

If this option is to be adopted in spite of all the inherent disadvantages, then the ratios should be calculated using raw actual opex, rather than opex that has already been adjusted due to historic capitalisation policies.

Adding an explanatory variable to the econometric benchmarking models that directly captures capitalisation practices

More information is needed to provide feedback.

Benchmarking on the basis of DNSP's current capitalisation policies

Benchmarking based on DNSP's current capitalisation policies has the advantage of ensuring the benchmarking results reflect actual opex paid for by customers today.

The AER observes that if current capitalisation policies are applied in benchmarking, this improves the score of all networks given the frontier network's score shifts downwards. This narrows the gap between the benchmark comparators and other DNSPs. It is possible that this represents an improvement in the accuracy of the benchmarking as networks have been operating under strong efficiency incentives for some time and have all been taking steps to improve their efficiency – intuitively performance should converge over time. However, before the 0.75 benchmarking comparator point is increased as a result of this convergence, there are various other material aspects of benchmarking that need to be further developed through a holistic benchmarking review, to restore stakeholder confidence in the accuracy of the benchmarking results.

Under this option we do not see a need for a post-modelling adjustment for capitalisation practices (i.e. capex/opex trade-offs), as suggested by the AER. Our rationale for this is explained above.

Obtaining efficiency scores on the basis of a common opex/capital ratio applied to all businesses

As demonstrated earlier, the opex/capital ratios do not correlate to capitalisation differences. Therefore, this option would yield a similar outcome (and disadvantages) to the AER's first option of applying an OEF adjustment for capitalisation using opex/capital ratios.

In addition this is akin to totex, rather than opex, benchmarking. If this approach is adopted the role of the benchmarking in the AER's opex decisions will need to be reconsidered.

Benchmarking on the basis of a fixed proportion of overheads

This aligns with part of our preferred approach described in section 3.4. The merits of this approach are set out above.

The consultation paper contains only a short discussion of option 5. The reason for its relatively poor performance on the criteria of 'validity/ fitness for purpose' and 'accuracy/ reliability' in Table 3 is not clear. This is a more direct and accurate fix for the capitalisation issues the AER should address.

The AER is concerned that this approach means the benchmarking is an artificial construct that does not reflect the way that networks do business. While this is correct, it is not necessarily a concern, if the purpose of the benchmarking is to compare the relative efficiencies of networks and this adjustment would improve its accuracy in comparing this. We note that this critique is equally applicable to the current benchmarking approach in which material opex for Powercor and Citipower is excluded on the basis of historical practice (i.e., it does not reflect how these networks do business today).

Another concern raised is that this measure would not adequately account for differences in cost allocation between overheads and direct costs. Networks generally allocate very similar costs to corporate overheads, and this can be monitored over time to understand if allocations change and if the approach remains fit for purpose. The allocation differences are more pronounced for network overheads, and for this reason we suggest limiting the adjustment to corporate overheads and monitoring over time.

While this option does not account for opex/capex trade-offs, as explained above we think the AER should directly adjust the benchmarking input data for specific opex/capex trade-offs.

Introducing a common capitalisation policy for benchmarking

We do not agree with this option because we do not consider it would be a material improvement compared to our preferred approach, and it would introduce a new set of systems and approaches and significantly increasing our regulatory burden and compliance costs.

5.3 What are your views about the advantages and disadvantages identified for each of these options and how the assessment principles are considered? Do you consider there are further issues that should also be taken into account, and if so, what are they and why are they relevant?

This question is addressed above.

5.4 Do you agree or disagree with our preferred option of applying an OEF adjustment informed by opex/capital ratios? Please provide arguments to support your view. Do you agree with our view that this approach is appropriately agnostic on the source of capitalisation practices differences between capitalisation policy and opex/capital trade-offs? If not, please provide reasons why you consider that there should be differential treatment of these two sources of capitalisation practices.

We disagree with the AER's preferred option of applying an OEF adjustment informed by the opex/capital ratios for the reasons outlined above.

5.5 Do you have a different preferred approach? Please outline what this is and provide supporting arguments about why this is considered to better address the material impacts of capitalisation differences on the benchmarking results.

See section 3.4.

5.6 Assuming for present purposes that we adopt our preferred approach (Option 1), what are your views on which ratios should be used to drive the OEF adjustment?

As we have demonstrated above, the high-level ratios are fraught with problems that make them unsuitable correction factors for capitalisation differences. The use of these ratios would lead to erroneous results and adjust for a multitude of factors outside of capitalisation differences and opex/capex trade-offs, which also provide contradictory results for 4 out of the 13 DBs in question. It is our view that any adjustment factors need to improve the accuracy, and not erode, the benchmarking results.

If the AER can demonstrate that the ratios strongly correlate with capitalisation differences (and not another factor such as firm size), then the weighting should reflect the degree to which they appropriately reflect capitalisation differences.

Additional Benchmarking Issues to Resolve

AusNet would like to raise the following additional benchmarking issues for the AER's consideration.

Guaranteed Service Level (GSL) Payments

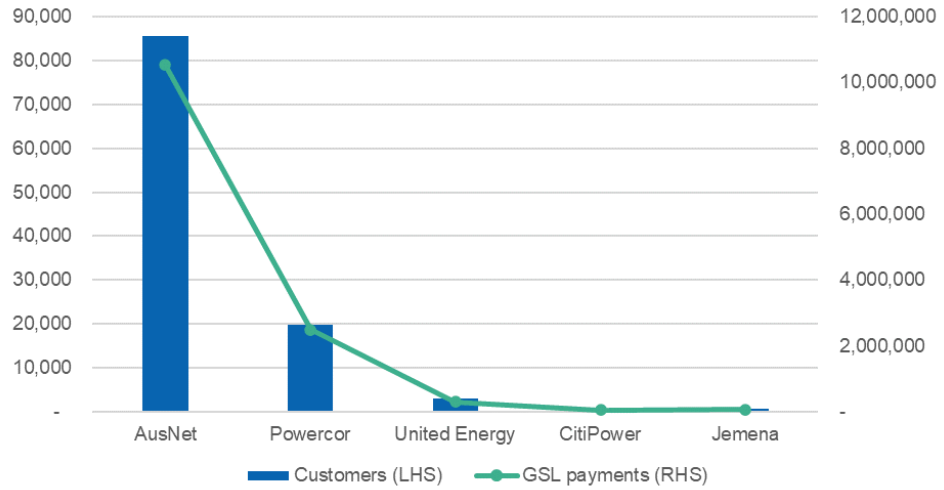
GSLs are payments that are made to our customers who experience the poorest levels of reliability. These payments are funded from our wider customer base and are a transfer of funds from one group of customers to another with no bearing on network efficiency.

The benchmarking includes the cost to customers but not the benefit of the payments. This is not appropriate – the opex benchmarking should either include the value to customers of the GSL payments as an output, or if this is too difficult in practical term, should remove GSLs from the opex input. We note these two approaches should give identical outcomes.

In addition, as we have previously raised including GSL opex as an input double counts poor reliability, as these are payments for poor reliability which is already included in the benchmarking through the reliability output.

GSL payments can be very material, particularly for AusNet's customers. We pay materially more GSL payments to our customers than any other network. A comparison of Victorian GSL payments made in 2020 is below.

Figure 2: Actual GSL outcomes (reliability of supply only) in 2020



Source: AER, Raw data from annual RIN responses

This will continue to be a material issue. AusNet recently paid $25.6 million in GSL costs for the major storms on 9th and 10th June 2021 following a Victorian Government direction We request this issue is considered and addressed by the AER prior to the next benchmarking report.

Cost Pass Throughs imposing one-off costs with no bearing on outputs

The AER has received several cost pass through applications in recent years associated with natural disaster events. These events are outside of the control of networks and the opex incurred has no bearing on the underlying efficiency of the network. Including opex associated with these events in the benchmarking will distort its results.

Opex associated with these events should be excluded from the benchmarking. Exclusion of these one-off costs is supported by:

- The reliability output in the model is net of exclusions – the reliability impacts of these major events are not included in the benchmarking so the costs should not be either; and
- One-off costs (such as pass through events) are excluded from the opex base year when the AER is assessing its efficiency in the determination process, as they are unrelated to whether the base year is efficient.

Operating Environment Factors

The AER has developed a vegetation management OEF in the Victorian resets, using forecast opex from the VBRC pass through applications. While this is a positive step forward, it does not fully capture the increased opex associated with having the highest bushfire risk in Australia. This is because:

- VBRC pass through does not account for opex associated with more recent safety obligations such as REFCLs.
- It also does not account for higher insurance premiums due to higher bushfire liability risk exposure compared to other networks.
- Additional vegetation management costs beyond those captured in the VBRC pass through.

We support further development of the OEF framework through the holistic benchmarking review we recommend. This should include considering whether the current range of OEFs are fit for purpose and the potential to improve these. It is important to do this outside of regulatory determination processes to ensure stakeholders can engage on an equal footing. In determination processes, as is unavoidable, the network subject to that determination will have a great level of engagement with the AER as it refines its approach, which may not lead to accurate outcomes.