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Sebastian Roberts
General Manager, Network Expenditure
Australian Energy Regulator

By email: AERInquiry@aer.gov.au

Dear Mr Roberts

CitiPower, Powercor and United Energy submission to AER Capitalisation

CitiPower, Powercor and United Energy welcome the opportunity to provide comments on the Australian Energy Regulator's (AER's) consultation paper on how it will assess the impact of capitalisation differences on benchmarking. Our businesses remain supportive of benchmarking as one of a suite of assessment tools. We therefore encourage the AER to ensure its benchmarking approach is robust and fit for purpose. We also encourage the AER to expand its benchmarking metrics to recognise the importance of customer outcomes in terms of price and service quality to improve the incentive on businesses to deliver beneficial customer outcomes.

It is appropriate from a regulatory principles perspective to continuously improve benchmarking with a long-term view to accuracy, robustness and reliability. Ensuring long-term robustness in the benchmarking methodology will promote a stable and consistent regulatory environment for businesses to improve their service delivery and promote stakeholder confidence in the credibility and usefulness of benchmarking results.

The intent of operating expenditure (opex) benchmarking is to assess the relative efficiency of each network's opex, while accounting for Operating Environment Factors (OEFs) that can lead to material differences in opex between networks that are unrelated to efficiency. However, if an OEF adjustment inadvertently captures network inefficiencies rather than just differences in environmental factors, application of the OEF will undermine the intent of benchmarking and materially reduce the accuracy and reliability of benchmarking results. In our view, the OEF adjustment for capitalisation policy proposed by the AER under option 1 does unintentionally adjust for inefficiency, as well as capitalisation policy (reasons discussed below).

To ensure benchmarking remains fit for purpose, we recommend that:

- **the most appropriate solution is adjusting each network's benchmarked opex based on a fixed proportion of allocated corporate overheads** (option 5). This approach is an economically sound adjustment that does not capture network inefficiencies, which targets the most material issue, can be implemented in a short timeframe and has existing stakeholder support. We strongly recommend that the AER implements this approach, potentially in conjunction with the development of a longer-term common capitalisation policy for benchmarking purposes
- **ideally the AER would establish and implement a common capitalisation policy among networks for the purposes of benchmarking** (option 6) that properly controls for the differences in capitalisation policies between networks, including accounting treatment of overheads and opex-capex substitutions. This common policy would account for capitalisation policy differences between networks in a targeted way that avoids capturing network efficiencies in its adjustments. We do however recognise that this approach would be time and resource-intensive for both the AER and stakeholders, and its practical viability would need to be further assessed

- **if the AER continues to believe that adjusting for a fixed proportion of corporate overheads or undertaking a broader review of capitalisation policies is not appropriate**, it should use current capitalisation policies as the basis for an adjustment (option 3). This type of adjustment is the most simple and straightforward approach because networks already provide the required information in the Economic Benchmarking Regulatory Information Notice. This approach is also more targeted towards capitalisation policies and less likely to indirectly capture network inefficiencies in its adjustment than the AER’s option 1 and 4 (discussed below)
- **the AER does not implement adjustments based on any of its opex/totex, opex/total cost and opex/total inputs ratios** (option 1 and 4) because the adjustment will account for network efficiencies and undermine the reliability and accuracy of benchmarking results. This type of adjustment will in practice adjust for inefficiency as networks with relatively higher levels of opex will appear more efficient, while networks with relatively lower levels of opex, and have delivered opex efficiencies, will appear less efficient. This approach essentially punishes the achievement of efficiencies and rewards inefficiency. We also note that the outcomes under each of the AER’s proposed opex/capital adjustments vary significantly both for each network and depending on the year of assessment. This is a strong indication that the approach is not a robust or reliable measure of capitalisation practices.

If you have any questions regarding this submission or would like to discuss its content, please contact [REDACTED] at [REDACTED]

Yours sincerely,

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[REDACTED]
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Applying an ex-post OEF adjustment or applying a common opex/capital ratio undermines the intent of benchmarking

The currently preferred AER approach is its option to apply an ex-post OEF adjustment to opex benchmarking scores based on its opex/totex, opex/total cost, and opex/total inputs (collectively referred to by the AER as opex/capital ratios) to account for the difference between each network's capitalisation policy and the benchmark comparator policy, identified as option 1 in the Consultation Paper. The AER has previously applied this approach to Jemena's 2021-2026 determination and Evoenergy's 2014-2019 determination.

Applying an ex-post OEF adjustment based on the proposed opex/capital ratios will in practice adjust for inefficiency as networks with relatively higher levels of opex improve efficiency scores. Similarly, networks that have found opex efficiencies and have a relatively lower level of opex would effectively be punished for achieving efficiencies through a negative adjustment resulting in lower efficiency scores.

The intent of opex benchmarking is to assess the efficiency of each network's opex, taking account of environmental factors that can lead to material differences in opex between networks. OEF adjustments should be made so that the benchmarking results after OEF adjustments better reflect network efficiency levels. Implementing an OEF adjustment that captures inefficiencies will lead to benchmarking results that are poorer reflections of network efficiency levels, again undermining the intent of network benchmarking and reducing the usefulness of benchmarking results for stakeholders and the AER's assessment.

Further, we note that the outcomes under each of the AER's proposed opex/capital adjustments vary significantly both for each network and depending on the year of assessment. This is a strong indication that the approach is not a robust or reliable measure of capitalisation practices.

OEF adjustments must be implemented carefully so that they capture the differences in relative opex spend directly due to differences in operating environments between networks, but do not account for material differences in efficiency that benchmarking is trying to measure. We are supportive of positive incremental change to the benchmarking methodology, including the implementation of appropriate and targeted OEF adjustments. However as outlined, we do not believe that a capitalisation policy OEF adjustment is appropriate or targeted, rather that it is more likely to reduce the reliability of results.

Overall, we strongly recommend that the AER does not implement an ex-post OEF adjustment based on opex/capital ratios because it will inadvertently account for network inefficiencies and reduce the usefulness of benchmarking results, especially given that there are more appropriate and robust alternative options.

Similar poor outcomes will result from the implementation of the AER's option 4 in its Consultation Paper, to obtain benchmark efficiency scores based on applying a common opex/capital ratio applied to each network's opex. This approach impacts network efficiency in a similar way as an ex-post OEF adjustment based on opex/capital ratios. This is because for the purposes of benchmarking, it effectively lowers the opex of networks with relatively higher levels of opex and increases the opex of networks with a relatively lower level of opex, without any direct link to accounting treatment of overheads or identified opex-capex trade-offs. We do not support the implementation of a common opex/capital ratio applied to all networks' opex because like an ex-post OEF adjustment, network inefficiencies will be unintentionally captured and accounted for in the adjustment.

Opex/total inputs is not an appropriate ratio under any scenario

If the AER continues to believe that an ex-post OEF adjustment based on opex/capital ratios is its preferred approach despite the approach also capturing inefficiencies, we recommend the use of the opex/totex and opex/total cost ratio and exclusion of the opex/total inputs ratio, similar to the approach taken in Jemena's 2021-2026 determination.

Opex/totex is the most likely ratio to account for dollar-for-dollar opex and capex trade-offs, for instance in the treatment of overheads. Opex/total cost is a cost-based measure that is consistent with the AER's approach to benchmarking and the annual user cost of capital is a determinant of total costs to customers.

Opex/total inputs is not an appropriate measure to adjust for capitalisation policies because it has little relevance on changes in capitalisation policy. A network's current asset inputs are a measure of the degree of investment made over the last half a century and do not materially change based on a network's current capitalisation policy. Additionally, historical network investment decisions are not representative of current capitalisation practices. Current capitalisation practices are influenced by recent accounting standard changes, as well as increased prevalence and efficiency of cloud-based ICT solutions and greater opportunities for demand management.

It is important to reiterate that an OEF adjustment based on any of these ratios is not a first, second or third-best approach to adjusting for capitalisation policies because inefficiencies will be captured in the adjustment.

An adjustment to the treatment of corporate overheads is the most direct, reliable, appropriate and practical approach

On balance, adjusting each network's opex in the benchmarked opex series based on a fixed proportion of allocated corporate overheads is the most appropriate approach because it is economically sound, directly targets the most material capitalisation policy issue, can be implemented in a short timeframe and has existing stakeholder support. We strongly recommend that the AER implements this approach.

Whether corporate overheads are treated as opex or capex by each network is likely to have a negligible impact on the true efficiency of the business. However, the treatment of corporate overheads for benchmarking purposes does have a material impact on opex benchmarking outcomes. Applying a fixed proportion of corporate overheads to each network for benchmarking purposes is an economically sound approach because it will not inadvertently capture any material inefficiencies in the adjustment. Adjusting the opex benchmarking methodology to include a fixed proportion of corporate overheads in the opex series will lead to a higher level of accuracy and reliability in benchmarking results.

The treatment of corporate overheads in benchmarking is expected to be the most material and most pressing capitalisation related issue impacting the level of opex used in the benchmarking models. For example, expensed corporate overheads currently account for around 40 per cent of our networks' total opex. Addressing variations in corporate overhead capitalisation by fixing a proportion of corporate overheads to be allocated to opex for benchmarking purposes would directly deal with this issue.

Adjusting the treatment of corporate overheads is a relatively straightforward concept and it would be a short and simple process to implement. The data to undertake the analysis is readily available for all networks and over time in the Regulatory Information Notices. Additionally, adjusting the treatment of corporate overheads could be implemented in the short term alongside a longer-term solution such as developing a common capitalisation policy for the purposes of benchmarking to manage the residual concern of opex-capex trade-offs. Pursuing both of these solutions would resolve the most material issue essentially immediately and develop a fit-for-purpose treatment of capitalisation policies for benchmarking capable of long-term robustness.

We also understand that the majority of stakeholder concerns with benchmarking capitalisation have been about the treatment of corporate overheads. Given the economic rationale to apply a targeted adjustment to the treatment of corporate overheads is sound and the amendment to benchmarking methodology is relatively simple to understand, we believe that broader stakeholder support could be achieved.

The AER outlines concern in its Consultation Paper that this approach would not be reflective of actual costs or capitalisation practices and may be an artificial construct that does not accurately reflect how Distribution

Network Service Providers (DNSPs) conduct their business¹. We believe that any type of adjustment to the treatment of capitalisation in benchmarking could be considered an artificial construct because by the nature of adjusting the treatment of capitalisation policies in benchmarking, would no longer reflect actual capitalisation practices. However, the purpose of this consultation is to improve the effectiveness of opex benchmarking by accounting for and adjusting capitalisation factors that impact opex but are unrelated to efficiency. For the reasons outlined above, adjusting for corporate overheads is the best practical option that improves the accuracy and reliability of opex benchmarking.

The AER also outlines concern in its Consultation Paper that this approach would not adequately account for differences in the allocation or classification of other costs between DNSPs or account for opex/capex trade-offs². We agree that these aspects of capitalisation also need to be addressed and we suggest that a broader review of capitalisation policies is warranted to directly address these concerns in a way that does not consequently account for network inefficiencies. As outlined earlier, an immediate amendment to the treatment of corporate overheads that addresses the most material benchmarking issue in a simple and transparent way could be supported by a long-term review to design a targeted and comprehensive common capitalisation policy used for benchmarking.

A broader review of capitalisation policies is warranted

Consistent with our views on long-term policy development, the first-best approach to addressing differences in capitalisation policies between networks is for the AER to establish and implement a common capitalisation policy among networks for the purposes of benchmarking (option 6 in its paper).

This approach would control for the differences in capitalisation policies between networks, including the treatment of overheads and opex-capex substitutions, in a comprehensive and targeted way. A detailed, targeted approach is likely able to be designed such that it accounts for differences in capitalisation policies to the greatest extent possible while avoiding capturing network inefficiencies in any adjustments.

We do however recognise that this approach would be time and resource-intensive for both the AER and stakeholders, and its practical viability would need to be further assessed. From a long-term regulatory principles perspective, we believe that developing a common capitalisation policy remains the most robust and comprehensive way to deal with capitalisation issues and could be undertaken following an immediate adjustment to allocate a fixed proportion of corporate overheads (option 5) as discussed above.

If the AER continues to believe that adjusting for the treatment of corporate overheads or undertaking a broader review of capitalisation policies is not appropriate, it should use current capitalisation policies

If the AER believes it needs to make adjustments on a broader basis of capitalisation rather than just corporate overheads, it would be adequate to use the current capitalisation policies of each network. This approach would adjust for current network practices, while also being more robust than the AER's options 1 or 4.

¹ Australian Energy Regulator, [How the AER will assess the impact of capitalisation differences on our benchmarking – Consultation Paper](#), November 2021, p. 36.

² Australian Energy Regulator, [How the AER will assess the impact of capitalisation differences on our benchmarking – Consultation Paper](#), November 2021, p. 36.

Benchmarking on the basis of current capitalisation policies is the most simple and straightforward approach presented by the AER because networks already provide the underlying data required through the existing Economic Benchmarking Regulatory Information Notice. This approach would effectively bring forward the benchmarking methodology to reflect the current capitalisation approach of networks. We consider this approach is more likely to meaningfully address the treatment of corporate overheads without undermining the intent of benchmarking to assess relative efficiency. However, the underlying issues of networks having different approaches to capitalisation would not be addressed under this approach.

We are not concerned that future benchmarking report results would not be comparable to previous benchmarking report results because the results can be backcasted from the year of the most recent benchmarking report, ensuring that the most recent benchmarking report is the most reliable source of the relative efficiency between networks. Previously identified errors in the benchmarking models have already resulted in discontinuity between successive benchmarking reports, reducing the materiality of this issue further. We are also not aware of any stakeholders that refer back to previous iterations of benchmarking reports given each year's report provides the historical timeseries and results.

We support the AER's commitment to a broader review of its benchmarking methodology

We welcome the opportunity to engage in the AER's broader benchmarking methodological reviews, including:

- the assessment of further options for improving the reliability performance of the translog econometric opex cost function models
- an independent review of the non-reliability output weights used in the TFP/MTFP benchmarking
- investigating whether changes may be required to account for distributed energy resources in benchmarking.

Addressing these, and other technical issues previously raised, will improve the accuracy and reliability of benchmarking, and drive an increase in stakeholder confidence in the overall benchmarking approach going forward.