18 February 2022

Sebastian Roberts
General Manager
Network Expenditure
Australian Energy Regulator
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Dear Mr Roberts

IMPACT OF CAPITALISATION ON THE AER'S BENCHMARKING

Energy Queensland Limited (Energy Queensland), on behalf of its distribution businesses, Energex Limited (Energex) and Ergon Energy Corporation Limited (Ergon Energy), welcomes the opportunity to comment on the Australian Energy Regulator's (AER's) consultation paper on how the AER will assess the impact of capitalisation differences on its benchmarking.

Energy Queensland considers that capitalisation practices differ materially amongst distribution network service providers (DNSPs) and this materially impacts on the AER's benchmarking results. We welcome the AER seeking options to address the issue. We strongly agree that benchmarking must be undertaken using comparable and consistent data in order to properly reflect differences in how DNSPs are efficiently delivering network services. This is critically important in a context where the AER's benchmarking plays a determinative role in setting operating expenditure (opex) allowances.

We consider that the AER's proposed definition of capitalisation practices to include both capitalisation policies and capital expenditure (capex) and opex trade-offs is fairly comprehensive. While we note that there are limitations with opex/capex ratios, we believe that they provide a simple and transparent approach for assessing the materiality of differences in capitalisation practices as well as calculating the operating environmental factor (OEF) adjustment.

However, we have concerns with the AER's preferred approach of continuing to 'freeze' the 2014 capitalisation practices as reflected in the cost allocation methods (CAMs) in place at that time. The AER prefers this approach for two main reasons. Firstly, based on the advice from its consultant, Economic Insights, the AER considers that this approach minimises the scope for gaming of the benchmarking via reallocation of opex and capex. In addition, the AER considers that this approach provides for a continuity of benchmarking scores.

In Energy Queensland's view, the shortcomings of freezing the 2014 capitalisation practices outweigh the benefits set out by the AER. Given the impact of benchmarking on opex allowances, specifically the use of benchmarking to directly inform 'efficiency adjustments,' it is more important that the AER's benchmarking is transparent and accurate. Furthermore, the opex used in benchmarking models should be consistent with the allowances set by the AER and what customers ultimately fund over the regulatory period. In our view, the opex used by the AER must reflect current capitalisation policies, CAMs and corporate structures.

Moreover, some changes to capitalisation practices, CAMs and corporate structures cannot be back cast with a high degree of accuracy. This is an issue currently facing Energex and Ergon Energy, where the structure of the businesses is now fundamentally different to that in 2014, following the formation of Energy Queensland. Back casting for some of the changes is extremely burdensome if not impossible. For example, information communications and technology (ICT) assets, were not previously included in the distributors' RAB and were held in a sperate jointly owned ICT service provider, with the costs flowing through to the distributors as overheads. That model cannot be replicated, which reduces the accuracy of the back cast opex.

Energy Queensland appreciates that continuity in benchmarking score is desirable. However, changes are essential to the extent that they improve the accuracy of the benchmarking. In this regard, we note that since the development of the AER's benchmarking approach, the AER has made changes to its benchmarking that reduced comparability of benchmarking reports. This includes the correction of the coding error in 2020, which had the effect of materially changing the relative performance of Energex and Ergon Energy to that from earlier reports.

We submit that our preferred option is for the AER to benchmark businesses based on current capitalisation practices as reflected in the current CAMs and apply a post-modelling OEF for material differences in the current capitalisation practices (if any).

Should you wish to discuss any aspect of this matter further, please contact me on [redacted].

Yours sincerely

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Manager AER 2025

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