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Dear Mr Roberts

## **Evoenergy submission to the AER's consultation paper on the impact of capitalisation differences on benchmarking**

Evoenergy welcomes the opportunity to make a submission to the Australian Energy Regulator's (AER's) consultation paper on how it will assess the impact of capitalisation differences in its benchmarking.

We also commend the AER for initiating this review as part of its ongoing benchmarking development work program flagged in the 2021 Annual Benchmarking report. We note that a number of stakeholders have raised concerns over several years about the risk of differences in capitalisation practices between DNSPs distorting benchmarking outcomes. It is pleasing that the AER has shown responsiveness to these stakeholder concerns by commencing this review, and we encourage the AER to undertake similar reviews on the other areas for development identified by the AER in the 2021 Annual Benchmarking Report.

### ***We support the AER's proposed timetable for confirming its approach by August 2022***

We consider it is important to progress and resolve this issue well in advance of the next set of distribution revenue determination proposals that are due in January 2023. The AER has also noted that further refinement of its benchmark approach cannot occur until it has considered and addressed the impact of capitalisation.<sup>1</sup> We therefore support the AER's proposed process and timeline for developing its final guidance on this issue by August 2022. We also appreciate the AER putting forward its preliminary views to progress this issue and enhance the review process.

### ***We agree with the AER's preliminary views***

We agree with the AER's preliminary views that:

- some DNSPs' capitalisation practices are materially different to those of the comparator DNSPs;
- these differences can lead to differences in operating expenditure (opex) and capital expenditure (capex) unrelated to true efficiency, and are likely to have a material impact on the AER's benchmarking results; and

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<sup>1</sup> [AER, How the AER will assess the impact of capitalisation differences on our benchmarking – Consultation Paper, November 2021, p 11.](#)

- applying an operating environment factor (OEF) adjustment to the benchmarking results, based on opex/capital ratios, is the most reasonable and pragmatic approach to address the impact of capitalisation differences on the benchmarking results.

We discuss our views on the AER's proposed approach further below. We note that while the AER's proposed approach has some limitations, it has the benefits of being consistent with the AER's approach to date, can be readily implemented and is relatively simple and transparent.

***The AER's proposed approach of applying an OEF adjustment to DNSPs' efficiency scores to reflect material departures from benchmark comparators' capitalisation practices***

Under the AER's proposed approach, it would make an OEF adjustment to the DNSPs' efficiency target scores (currently 0.75) to account for the possibility that each DNSP's capitalisation practices may be materially different to the capitalisation practices adopted by the reference DNSPs.

The adjustment would be based on the percentage divergence of the DNSP's opex/capital ratio relative to the comparator-average ratio. The opex/capital ratio would be a combination of:

- the opex/totex and opex/total cost ratios, with a weight of 0.5 assigned to each (as recently adopted in the Jemena final determination); or
- a combination of the opex/totex, opex/total cost and opex/total inputs ratios, with weights of 0.5, 0.25 and 0.25, respectively.

The AER's proposal to use two to three specific types of opex/capital ratios recognises that each has its own advantages and disadvantages.

The AER's proposed approach would also involve continuing to benchmark DNSPs based on the 2014 capitalisation policies, to protect against any changes to capitalisation policies DNSPs may have made over time and to provide for continuity of benchmarking scores.

The AER's proposed approach is consistent with its general approach of adjusting the target level of efficiency for material and exogenous factors not otherwise accounted for in its benchmarking analysis (i.e., the 'ex-post OEF approach'). Specifically, the adjustment based on the opex/capital ratios would seek to account for differences between DNSPs' capitalisation policies and/or opex/capital trade-offs that may drive different levels of opex amongst DNSPs but which are not related to efficiency.

This approach is also consistent with the AER's approach to date in addressing this issue (for Jemena in its 2021-26 revenue determination and Evoenergy in its 2015 revenue determination). Importantly, this shows the approach can be readily implemented. It is also relatively transparent and simple.

The AER, however, identifies potential downsides to its proposed approach. It notes that freezing 2014 capitalisation policies for benchmarking purposes would mean there is a growing divergence between the capitalisation policies used to assess the efficiency of opex via the benchmarking and the capitalisation policies used for setting opex allowances. The AER also recognises that another potential problem with continuing with the frozen 2014 capitalisation policies is the quality of the opex series, specifically whether it is subject to the same level of

quality assurance (e.g., external audit) as the opex series under the capitalisation policies that underpin reported opex.

Evoenergy also notes that the AER's general approach to making ex-post OEF adjustments to DNSPs' efficiency scores after modelling (which uses unadjusted, non-comparable data) has been undertaken to determine these scores is problematic. Under this approach, some DNSPs may be identified as 'reference' DNSPs simply because the AER's benchmarking models have not accounted properly for all of the inherent differences between DNSPs, rather than because those DNSPs are truly the most efficient peers. Similarly, other DNSPs may be identified as inefficient, again due to the AER's benchmarking models' inability to account for all relevant differences between DNSPs. The Australia Competition Tribunal noted in 2016 that it would be preferable for the data used in the benchmarking analysis to be adjusted and normalised to improve comparability before applying it to a benchmarking model to determine the efficiency scores (i.e., an ex ante approach to adjusting for OEFs).<sup>2</sup>

We note that any approach to address the issue of different capitalisation practices in the benchmarking analysis will have its limitations and support a pragmatic approach to addressing this issue.

We therefore support the AER's proposed approach of applying an OEF adjustment for capitalisation using two to three opex/capex ratios as a reasonable, pragmatic and now established method of minimising the impact of differences in DNSP's capitalisation practices on benchmarking results. However, Evoenergy notes that this should not prevent the AER from undertaking further work in the future to determine whether all OEF adjustments could be implemented in an ex-ante fashion.

Further, we note that given the limitations cited above as well as other limitations observed in the overall methodology, a degree of caution should be exercised when using benchmarking to inform the AER's assessment of opex efficiency and the weight placed on benchmarking results should reflect its limitations when determining the forecast of efficient opex in DNSPs' distribution determinations.

***The AER can only account properly for differences in capitalisation practices using expenditure data that reflects 'unfrozen' CAMs***

As the consultation paper notes, the AER currently uses opex data that reflects 'frozen' 2014 CAMs for those DNSPs that have revised their CAMs over time. This ensures that the reported opex for individual DNSPs, used to conduct benchmarking analysis, is expressed on a comparable basis (i.e., using a single CAM) over time.

However, now the AER seeks to control directly for capitalisation differences between DNSPs by accounting for differences in one or more opex/capital ratios. Evoenergy submits that in order to control properly for actual capitalisation practices between DNSPs, it is necessary for the AER to compute these opex/capital ratios using expenditure data that reflect 'unfrozen' CAMs in each year. This would ensure that the opex/capital ratios for each DNSP reflects the actual capitalisation practices adopted by that DNSP in each year, rather than opex/capital ratios

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<sup>2</sup> [Applications by Public Interest Advocacy Centre Ltd and Ausgrid \[2016\] ACompT 1, p 109-110.](#)

derived using a CAM that has been 'normalised' over time. The use of data derived using 2014 frozen CAMs would fail to reflect the true capitalisation differences between DNSPs, thereby defeating the AER's attempts to account properly for these actual differences.

We look forward to participating further in this review process, to assist the AER in finalising its position and guidance on this issue as per the timetable outlined in its Consultation Paper. Please contact [REDACTED] at [REDACTED] if you would like to discuss our comments.

Yours sincerely



Peter Billing  
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