

14 February 2023

Arek Gulbenkoglul
General Manager
Australian Energy Regulator
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Canberra, ACT, 2601

By email to: AERInquiry@aer.gov.au

Dear Mr Gulbenkoglul

Evoenergy response to the AER's Draft Guidance note on how the AER will assess the impact of capitalisation differences on its benchmarking analysis

Evoenergy welcomes the opportunity to submit a response to the Australian Energy Regulator's (AER) Draft Guidance Note¹ on how the AER intends to account for differences in capitalisation practices when benchmarking the historical operating expenditure (opex) of distribution network service providers (DNSPs).

Evoenergy appreciates the AER's efforts in continuing to consult on this important issue and for refining its position on its preferred approach in response to stakeholder feedback and further analysis. Evoenergy welcomes the AER's ongoing development work to improve its benchmarking methodology.

Evoenergy agrees with the conclusions reached in the AER's previous Consultation Paper that:²

- capitalisation practices differ materially between DNSPs; and
- differences in capitalisation practices can distort benchmarking results materially if not accounted for properly within the analysis.

Evoenergy considers that accounting properly for differences in capitalisation practices is a challenging task and that there is unlikely to be a 'perfect' way to do this in practice. Evoenergy recognises that each of the options considered by the AER in the Draft Guidance Note has strengths and weaknesses. Hence, the task before the AER is not to choose the 'ideal' approach. Rather, the AER must make a pragmatic choice about the approach that is likely to distort the benchmarking outcomes the least.

¹ AER, *How the AER will assess the impact of capitalisation differences on our benchmarking*, Draft Guidance Note, October 2022.

² AER, *How the AER will assess the impact of capitalisation differences on our benchmarking*, Consultation Paper, November 2021.

Options considered by the AER in the Draft Guidance note

The Draft Guidance Note shortlists five mutually exclusive options for addressing material differences in capitalisation practices:³

- Option 1 – Apply an ex-post operating environment factor (OEF) adjustment for capitalisation to the benchmarking results under the DNSPs' 'frozen' 2014 cost allocation methodologies (CAMs) using opex/capital ratios.
- Option 2 – Add an explanatory variable to the econometric opex cost function modelling that directly captures capitalisation differences.
- Option 3 – Benchmark on the basis of DNSPs' current cost allocation methodologies (CAMs), with an ex-post OEF adjustment for capitalisation differences.
- Option 4 – Applying a common opex/capital ratio to all DNSPs as a pre-modelling adjustment.
- Option 5 – Benchmarking on the basis of a fixed proportion of overheads classified as opex for benchmarking purposes.

The Consultation Paper indicated that Option 1 was the AER's preferred approach. Evoenergy's response to the Consultation Paper supported Option 1 as being reasonable and pragmatic.⁴

However, Evoenergy noted in our submission that the AER's approach of 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. Evoenergy's submission explained that under this approach, some DNSPs may be identified as 'reference' DNSPs simply because the AER's benchmarking models have not properly accounted for all of the inherent differences between DNSPs, rather than because those DNSPs are truly the most efficient peers.

Similarly, other DNSP's may be identified as inefficient, again due to the AER's benchmarking models' inability to account for all relevant differences between DNSPs. Reflecting our general concern about the AER's extensive use of ex-post OEF adjustments, Evoenergy urged the AER to undertake further work in the future to determine whether all OEF adjustments could be implemented in an ex-ante fashion.

The Draft Guidance Note identifies a number of concerns with Option 1 and concludes that Option 5 is currently the AER's preferred approach.

Evoenergy's preferred option

Given the weaknesses that the AER has identified in relation to Option 1, and the shortcomings associated with ex-post OEF adjustments, Evoenergy supports the AER's current preferred option of normalising reported opex, by treating capitalised overheads as opex, before performing the benchmarking analysis (Option 5).

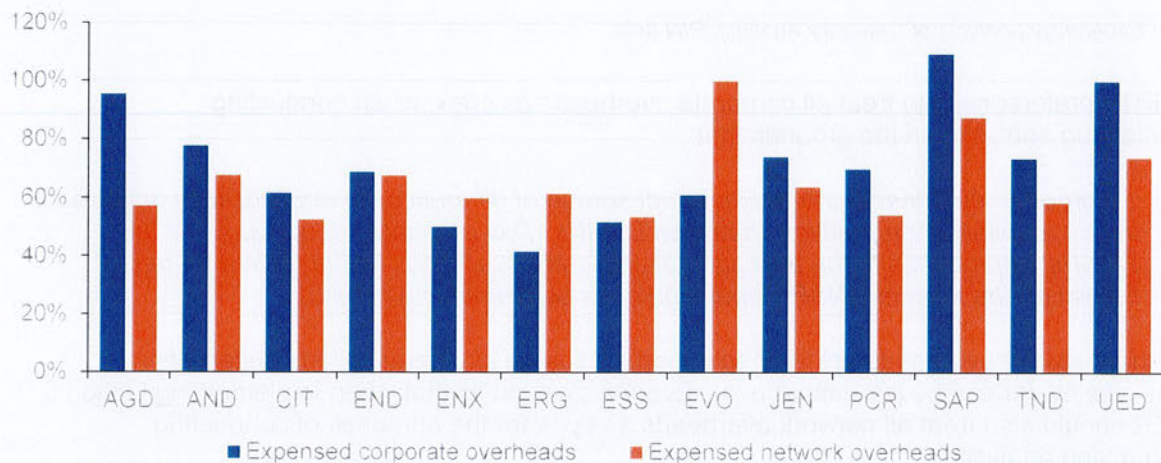
³ Draft Guidance Note, pp. 29-30.

⁴ Evoenergy, *Submission to the AER's consultation paper on the impact of capitalisation differences on benchmarking*, 18 February 2022.

However, Evoenergy considers that capitalised network overheads (in addition to capitalised corporate overheads) should be treated as opex for the purposes of accounting for differences between DNSPs capitalisation practices. Evoenergy notes there are a many categories of network overheads that could be treated by DNSPs as either opex or capex. Some examples include procurement and fleet management costs (as acknowledged in the Draft Guidance Note⁵), labour costs for network engineers (e.g., when engineering costs are allocated between planning of maintenance work (opex) and renewal/replacement/augmentation work (capex)), and control room costs.

This means that the way in which DNSPs treat network overheads as opex or capex can differ significantly. As shown in the Figure 1 below, the rate at which network overheads are capitalised or expensed varies considerably between DNSPs. Some DNSPs choose to expense a significant portion of their network overheads, whereas other DNSPs choose to expense a much smaller proportion of their network overheads.

Figure 1: Proportion of corporate and network overheads that are expensed by different DNSPs (average over the period 2009-20)



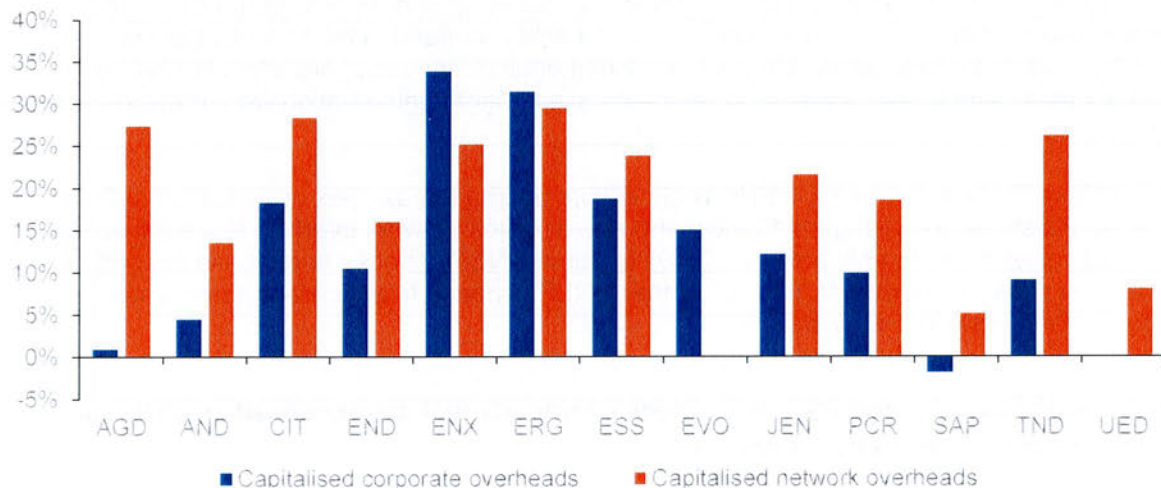
Source: Evoenergy analysis of Category Analysis RIN data.

The total amount of opex benchmarked can vary significantly between DNSPs depending on whether capitalised corporate overheads are included or excluded from total opex. Figure 2 below shows that the quantum of capitalised corporate overheads (expressed as a proportion of total opex) is very material for some DNSPs. The same is true for capitalised network overheads. That is, the total amount of opex to be benchmarked can vary significantly between DNSPs depending on whether capitalised network overheads are included or excluded from total opex.

This suggests that the results of the AER's benchmarking analysis are likely to be sensitive to whether capitalised network overheads are included or excluded from the measure of opex that is being benchmarked.

⁵ Draft Guidance Note, p. 64.

Figure 2: Capitalised corporate and network overheads as a proportion of total opex (average over the period 2009-20)



Source: Evoenergy analysis of Category Analysis RIN data.

The AER’s preference is to treat all corporate overheads as opex, when conducting benchmarking analysis, on the grounds that:

...corporate overheads, are an important source of differences in capitalisation policy and, in turn, capitalisation practices between DNSPs. This approach recognises that the DNSPs’ approaches to the allocation of corporate overheads would have a material impact on the level of DNSPs’ opex and opex benchmarking results.⁶

Given that network overheads are also an important source of differences in capitalisation policies—as evidenced by the data above—Evoenergy submits that when implementing Option 5 the AER should also treat all network overheads as opex for the purposes of conducting benchmarking analysis.

The AER’s reasoning in relation to opex/capex trade-offs

The AER suggests in the Draft Guidance Note that its econometric benchmarking models account indirectly for the differences in the opex/capex trade-offs made by DNSPs because the output variables used in those models are highly correlated with capital inputs. The AER concludes that if it adopts Option 5, it will not need to account further for differences in opex/capex trade-offs.

⁶ Draft Guidance Note, p. 63.

For example, the AER states that:

... we recognise that the econometric opex cost function models implicitly capture capitalisation to some extent through the existing output variables which are highly correlated with capital inputs. As a result, further adjustment may not be required.⁷

And that:

... due to the high correlation we have found between a capital input variable and the outputs in the econometric opex cost function model specification, we consider that opex/capital trade-offs are, to some but varying extent, captured implicitly in the econometric modelling.⁸

Evoenergy disagrees with the AER's reasoning in relation to this issue. The high degree of correlation between the output variables in the AER's benchmarking models and capital inputs is due to common scale effects. That is, large (small) DNSPs will tend to produce more (fewer) outputs and also tend to utilise more (fewer) capital inputs. Therefore, it is not surprising that the AER's selected output variables are highly correlated with the quantity of capital inputs used by DNSPs.

Evoenergy notes that there is a high degree of correlation between the various output variables specified by the AER in its benchmarking models, since all of these output variables reflect network scale to varying degrees. This does not mean that it would be reasonable or appropriate to exclude, say, the number of customer connections from the AER's benchmarking models on the grounds that the high degree of correlation between that output variable and other output variables would account implicitly for the number of customer connections if it were dropped from the models.

Analogously, it does not follow from the observation that there is a high degree of correlation between the quantity of outputs produced by DNSPs and the capital inputs used by DNSPs that the AER's benchmarking models account for opex/capex trade-offs.

Evoenergy considers that the AER is correct when it observes the following:

We recognise that as the approach focuses on capitalisation policy, it would not directly account for all opex / capital trade-offs,⁹

and that there are:

practical challenges with accurately making other broad adjustments for opex/capital trade-offs¹⁰

⁷ Draft Guidance Note, pp. 35-36.

⁸ Draft Guidance Note, p. 63.

⁹ Draft Guidance Note, p. 64.

¹⁰ Draft Guidance Note, p. 64.

Evoenergy submits that the AER should not overstate the extent to which Option 5 (or any of the other options it has consulted on) is capable of accounting for differences in capitalisation practices—including opex/capex trade-offs. Rather, the AER should acknowledge the limitations of the various approaches and (as Evoenergy suggested in response to the Consultation Paper) exercise a degree of caution when using benchmarking analysis to inform its assessment of opex efficiency. Evoenergy reiterates its previously submitted position that the weight placed on benchmarking results should reflect all of the limitations of that analysis when determining the forecast of efficient opex in DNSPs' distribution determinations.

The AER should continue to monitor the different options and review its approach periodically

Whilst Evoenergy supports the adoption of Option 5 (where total capitalised overheads, including capitalised network overheads, are treated as opex for all DNSPs), Evoenergy emphasises that none of the options canvassed by the AER are ideal solutions. Therefore, the AER should not consider this matter 'settled' once and for all. Rather, Evoenergy submits that the AER should proceed with Option 5 while continuing to monitor a range of suggested approaches in the absence of a perfect method to addressing differences in capitalisation practices between DNSPs in benchmarking analysis, accounting for the strengths and weaknesses of each option. This includes a future progress review of Option 5 (through a similar consultation process to the current one) in a few years to assess if it remains fit for purpose.

Please contact [REDACTED] if you would like to discuss any aspect of our submission.

Yours sincerely



Peter Billing
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