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Sebastian Roberts
General Manager, Network Regulation
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Sebastian,

Re: AER consultation on assessing the impact of capitalisation differences on benchmarking

Last month, as part of regular discussion on our upcoming distribution determination, we discussed with AER staff our findings on Power and Water's accounting treatment of corporate support costs relative to other network businesses and proposed changes to better align our accounting practices so that they were more consistent with our peers. At that meeting, AER staff encouraged us to share our findings as part of the AER's broader engagement on capitalisation differences for the purpose of benchmarking as it may be of assistance for the AER's review. The below is a summary of what we outlined in the discussion.

Power and Water is a multi-utility which provides a range of essential services across the Northern Territory, ranging from electricity, gas supply, water, and sewerage. Our three largest electricity networks (Darwin-Katherine system, Tennant Creek system, and Alice Springs systems) have only recently been subject to economic regulation under the Northern Territory National Electricity Rules (**NT NER**). Our first full determination under the AER began in 2019.

The issue of benchmarking is a particularly pertinent issue for Power and Water. We have been seeking to work closely with the AER to try and better understand how our comparability with other distribution network service providers (**DNSPs**) could be improved so that benchmarking could be applied to assess our efficiency in a meaningful way.

Benchmarking Power and Water to industry peers has proved challenging due to a range of issues. In addition to the complexity of developing appropriate operating environmental factors (**OEFs**) to normalise differences arising from the Northern Territory's unique operating circumstances, there are also inherent issues associated with our data quality and volatility in historical results that are difficult to explain.

We also expect that data reporting errors, accounting treatment, approaches to unit costing and cost allocation issues are likely to impede like-for-like comparisons across DNSPs. Inconsistencies in cost attribution and allocation to services is likely to diminish the integrity and increase the volatility of cost data given the broad range of services that Power and Water provides and the number of business units (and lines of business) which common costs are allocated across. We expect that some of these issues would have been experienced by other DNSPs but may have been addressed through convergence over time.

To try and better understand whether our accounting treatment of direct and overhead costs partly contributes to volatility in our reporting and variances in our benchmark results, we engaged external advice to benchmark our own accounting practices against industry peers. The external analysis looked at anecdotal data across a sample of nine distribution network businesses and found the following:

- Power and Water was the only business in the sample that followed two separate cost allocation methodologies – one for its statutory accounts and one for its regulatory accounts.
- Power and Water was the only business in the sample that did not allocated network and corporate support costs to work orders through its finance system.
- Power and Water was the only business that applied network overheads indirectly on a causal allocation basis.
- Power and Water was one of three business that applied corporate overheads indirectly on a causal allocation basis.

This finding prompted Power and Water to re-examine our accounting practices and options for aligning our accounting practices more closely with other DNSPs. Specifically, while Deloitte's review noted that we applied our CAM consistent with relevant requirements, our accounting approach towards overheads was inconsistent with other DNSPs resulting in our RIN data not being comparable with other DNSPs.

As part of our early engagement with the AER on our forthcoming regulatory proposal, we recently walked the AER through our proposed changes towards overhead capitalisation and cost attribution. The changes that we are proposing to make would result in Power and Water recovering overhead costs to work orders and/or capital projects to provide a better total cost estimate. In effect, this would amount to a shift away from indirect capitalisation of overheads based on cost centre activity and direct capex/direct total expenditure to direct capitalisation of overheads based on capital project assets (as a percentage of direct dollars on each work order or project).

This change in accounting treatment is consistent with our current CAM and capitalisation policy, however will uplift the value overhead costs being reporting in direct opex and capex activity our RINs. This will mean overheads as a percentage of gross capex currently 8 per cent will increase to 25 per cent which is more aligned to the industry average of around 17 per cent.

Consequently, it has been our experience that differences in accounting practices between DNSPs can drive differences in opex and capex outcomes and we are looking at ways to align our approach to industry peers.

It is important to note that this is only once area of discrepancy between Power and Water's business and peer networks. Further work still needs to be done around the accuracy and consistency of Power and Water's data relevant to peers including additional assessment of Power and Water's unique circumstances which have not been properly factored into benchmarking analysis at this time.

If you would you like any clarification regarding our response, please contact me by phone on [redacted] or by email [redacted]

Yours sincerely,

Brendon Crown
Senior Manager – Regulation, Economics, and Pricing

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