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Mr Sebastian Roberts  
General Manager, Network Expenditure  
Australian Energy Regulator  
GPO Box 520  
MELBOURNE VIC 3001

Email: [AERInquiry@aer.gov.au](mailto:AERInquiry@aer.gov.au)

Dear Mr Roberts,

### **Impact of capitalisation differences on AER's benchmarking**

SA Power Networks welcomes the AER's review of capitalisation practices, having advocated for a number of years for the AER to consider the impact of individual distribution network service providers (DNSPs) capitalisation practices on benchmarking outcomes. This letter responds to the Australian Energy Regulator's (AER's) 'How the AER will assess the impact of capitalisation differences on our benchmarking' consultation paper, dated 29 November 2021.

The AER uses economic benchmarking to measure how productively efficient networks are at delivering electricity distribution services over time and compared with their peers, reporting annually on the productivity growth and efficiency of DNSPs across the National Electricity Market (NEM). Economic benchmarking gives an important source of information on the efficiency of historical network expenditures and is used as part of the AER's assessment of a DNSPs operating expenditure as part of its revenue determination process. Where a DNSP's operating expenditure is deemed to be inefficient, an efficiency adjustment may be applied in determining the maximum revenues that can be recovered from customers over the period.

The AER's benchmarking is intended to reflect differences in DNSPs' operating efficiency, with all other major differences accounted for directly in the modelling or by adjusting the benchmarking results for differences in operating environment factors (OEFs). However, we note the current benchmarking approach does not include any assessment of capitalisation policies differences across DNSPs. We support a broad review of overhead cost allocation and capitalisation approaches and consideration of the likely impact this may have on benchmarking outcomes.

The AER's consultation paper considers capitalisation practices encompassing:

- Capitalisation policies, including the business' policies and/or specific methods of reporting or classifying expenditure as operating expenditure (opex) or capital expenditure (capex), as well as expensing/capitalising of overheads; and
- Opex / capital trade-offs, that is a business' utilisation of opex versus capital inputs, such as whether non-network Information Communication and Technology (ICT) services are provided predominantly through the use of cloud computing (opex) or through in-house equipment (capital inputs).

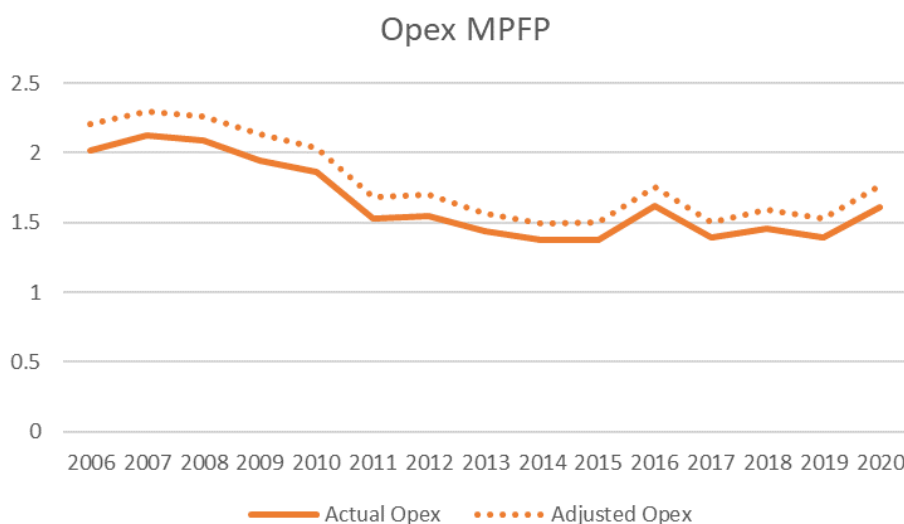
We consider these in further detail below.

### **Capitalisation policies**

DNSPs' capitalisation policies vary across the NEM, particularly in relation to the allocation of overheads. As an example, for regulatory accounting purposes, SA Power Networks allocates all corporate overheads as opex. This results in a comparative disadvantage in opex benchmarking (opex Multilateral Partial Factor Productivity (MPFP)), as SA Power Networks reports proportionately higher opex than other DNSPs who capitalise corporate overheads.

If SA Power Networks capitalised 30% of its corporate costs (the estimated average across all DNSPs), our reported opex would reduce by around \$21 million per annum (~9%). SA Power Networks' Opex MPFP would increase between 8% and 10% each year, with our 2020 Opex MPFP score increasing from 1.610 to 1.760, refer to Figure 1 below<sup>1</sup>. We would expect a similar result to the econometric modelling results.

**Figure 1 - Adjusted Opex MPFP - Capitalisation of Overheads**



While the application of corporate overheads varies across DNSPs, the core functions included within the build-up of corporate overheads are reasonably consistent. Examples of SA Power Networks' corporate support groups are Finance, Information Technology, Human Relations, Work, Health & Safety and Property Services. The build-up of network overheads tends to vary more significantly across DNSPs, with some businesses allocating a greater proportion of network support costs as a direct cost compared to other businesses.

We are supportive of adopting a consistent corporate overhead allocation rate across DNSPs, reducing some of the non-efficiency related variability in benchmarking outcomes. We do not consider any adjustments are required for network overheads.

We acknowledge that capitalisation practices are an internal management decision, however these decisions impact the relative opex benchmarking outcomes for factors other than efficiency.

<sup>1</sup> This modelling assumes no change in other DNSPs data over the same period.



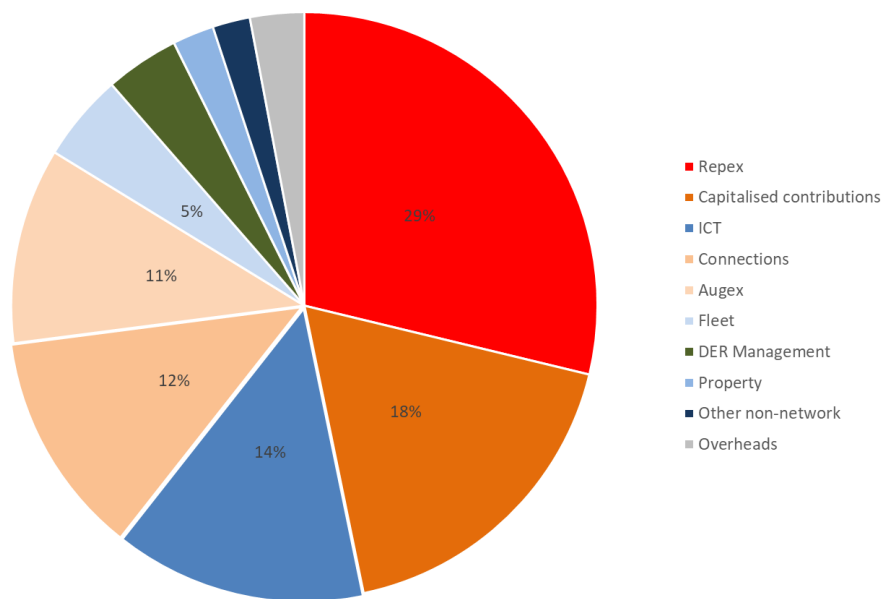
Noting the AER’s use of benchmarking outcomes deterministically, particularly in assessing the efficiency of a DNSP’s opex, it is important to consider the DNSP’s capitalisation policies and how this may be affecting its perceived relative efficiency as measured by benchmarking.

Overhead allocations are just one area where capitalisation practices may vary across DNSPs and affect benchmarking outcomes. SA Power Networks recommends the AER undertakes a detailed review of capitalisation practices across the NEM, with adjustments applied where required to ensure benchmarking and efficiency assessments correctly reflect relative outcomes.

SA Power Networks notes the AER’s proposed approach of using opex/capital ratios to assess differences in capitalisation practices. While these ratios provide useful measures in terms of ongoing business performance, they provide little correlation to capitalisation practices due to the variable nature of each DNSP’s capex. The total amount of capex reflects the capital required by the DNSP to build, maintain or improve the physical assets to provide its standard control services to the level expected by customers.

While SA Power Networks’ capex portfolio is similar in nature to other DNSPs, the amount of capex required across each category may vary. Figure 2, provides a summary of the drivers of SA Power Networks’ capex for the 2020-25 regulatory period.

**Figure 2 - Key drivers of SA Power Networks' capex – 2020-25 Final Decision**



The level of capex required for a DNSP will reflect the forecast level of growth in the network (new connections and augmentation), capital contribution levels, the asset age profile, asset replacement (repex) and safety requirements. The amount of capex is also driven by non-network expenditure requirements and customers’ take up of emerging technology solutions.

The cyclical nature of capital work means that some DNSPs may require more or less capex per year than other DNSPs, with capex varying across categories depending on the individual DNSP’s unique business requirements. In isolation, the total amount of capex does not provide insight into the relative efficiency of the DNSP in completing capital works.



## Opex / Capital Trade-offs

The level of opex and capex required is also affected by opex / capital trade-offs, ie business decisions to employ operating resources rather than capital resources in delivering standard control services.

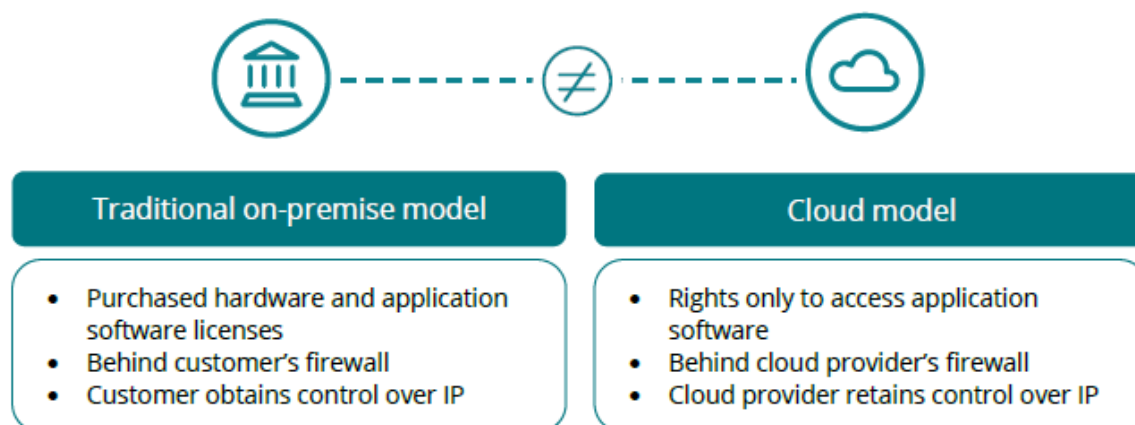
In some cases, moving to an opex based resource may be the only viable option available, for example more Information and Communications Technology (ICT) businesses are only providing access to their ICT software applications through cloud subscription services. This information is either stored by businesses on internal hardware, resulting in recurrent capex or through cloud subscription services known as Software-as-a-Service (SaaS).

Cloud infrastructure is a subscription based operating cost. In moving to cloud-based technology, we reduce our ongoing capital investment costs associated with updating and replacement of hardware. The efficient transition to cloud infrastructure, applications and services is changing our asset management approaches and decreasing ICT capex but increasing ICT operating costs. This can be challenging from a benchmarking perspective, as businesses will transition from ICT capex to opex at different times.

SA Power Networks forecasts recurrent opex costs to increase by approximately \$11 million over the 2020-25 regulatory period due to ongoing transition of ICT systems to cloud based services. This transition to cloud-based computing is expected continue for the foreseeable future, with a growing number of ICT vendors moving to only providing their services through SaaS solutions.

SaaS is a cloud computing arrangement in which the customer contracts to pay a fee in exchange for a right to receive access to the supplier's application software for a specified term. The supplier's software runs on cloud infrastructure managed and controlled by the supplier. The customer accesses the software on an as needed basis over the internet or via a dedicated line. Figure 3 provides a summary of the key differences between the traditional on-premise ICT service and the SaaS cloud model.

Figure 3 - Difference between on-premise and SaaS cloud models



SaaS has an additional complexity with regard to cost allocation. The International Financial Reporting Standards Interpretations Committee (IFRIC) recently clarified how arrangements in respect of a SaaS cloud technology should be accounted for. In March 2019, IFRIC concluded that SaaS arrangements are likely to be service arrangements, rather than intangible or leased assets. This is because the customer typically only has a right to receive future access to the supplier's software running on the supplier's cloud infrastructure and therefore the supplier controls the intellectual property (IP) of the underlying software code. As such the ongoing costs will be treated as opex.

In April 2021, IFRIC specifically considered how an entity should account for configuration and customisation costs incurred in implementing these (SaaS) service arrangements and concluded that these costs should be expensed, unless the criteria for recognising a separate asset are met. Consequently, all costs associated with implementing a SaaS arrangement that do not meet the criteria of being separately recognised as an asset will need to be opex.

Historically SA Power Networks has generally treated SaaS arrangements as if they were an on-premise software arrangement and accordingly these have been capitalised as intangible assets. For the 2020-25 regulatory period, SA Power Networks will continue to account for implementation costs associated with SaaS as capex for regulatory accounting purposes, ensuring consistency with the cost allocation practices within our 2020-25 regulatory determination.

This change in accounting practice, if adopted for regulatory accounting will have ramifications for benchmarking, with SaaS implementation costs being incurred up-front as non-recurrent opex costs. While these costs are considered non-recurrent, there are likely to be ongoing implementation costs incurred on a cyclical basis when major system upgrades are performed. SA Power Networks incurred costs of approximately \$8-\$10 million in the implementation of SaaS systems in 2020/21. We note, the amount of implementation costs will vary depending on the scope of the SaaS system being implemented, the amount of data to be converted to the new system and the staff training that may be required.

SaaS implementation costs are unrelated to opex efficiency and should be excluded from opex for benchmarking purposes. Inclusion of these costs, where material, would distort relative opex efficiency assessments of DNSPs across the NEM.

### ***Recommended approach to address capitalisation differences***

SA Power Networks does not support the use of opex / capital ratios to assess differences in capitalisation practices. These ratios provide little correlation to actual capitalisation practices due to the variable nature of each DNSP's capex. The variability of underlying capex and associated capitalisation practices of individual businesses, means that a simplistic OEF approach is unlikely to result in a consistent outcome for all businesses in terms of understanding their relative efficiency compared to others.

SA Power Networks' preference would be for the AER to undertake a detailed review of capitalisation practices across the NEM, with the intention of introducing a common capitalisation policy for benchmarking purposes (Option 6). We understand this will be more resource intensive for the AER and for DNSPs, however it is likely to provide the best long-term outcomes in terms of benchmarking consistency for all involved.

This review should be targeted to focus on the material elements of capitalisation differences, including the allocation of corporate overheads and opex / capex trade-offs. This review should also specifically consider the implementation costs associated with SaaS and how this should be treated for benchmarking purposes.

We look forward to continuing to work with the AER on this matter over the coming months. Please contact [REDACTED] on [REDACTED] if you require any further discussion or clarification of the above.

Yours sincerely



Patrick Makinson

EXECUTIVE GENERAL MANAGER GOVERNANCE AND REGULATION

GPO Box 77, ADELAIDE SA 5001

