AUSTRALIAN ENERGY REGULATOR

Explanatory note – EBIT per customer

The Australian Energy Regulator (AER) reports four regulatory profitability measures for regulated networks and accompanying explanatory notes.

This note explains our approach to reporting on earnings before interest and tax (EBIT) per customer for the gas distribution scheme pipelines. It also explains what factors to consider when interpreting these ratios. We do not report EBIT per customer for gas transmission network service providers.

This note discusses:

- What is EBIT per customer
- How to interpret EBIT per customer
- How we calculate EBIT per customer

What is EBIT per customer

EBIT per customer is a simple ratio of a DNSP's reported EBIT over the total reported number of customers connected to its network in a year.

EBIT per customer differs from other profitability measures that rely on asset or equity values and provides an alternative perspective on the drivers of operational profit margins.

$$\text{EBIT per customer} = \frac{\text{EBIT}}{\text{Customer Numbers}}$$

Where:

- EBIT is earnings before interest and tax in a year
- Customer numbers is the total number of customers connected to the network in that year

How to interpret EBIT per customer

EBIT per customer is best compared against the individual DNSP's past EBIT per customer. This comparison will track changes in the measure through time to identify drivers of variation in returns, such as variations in the capital base or allowed returns.

EBIT per customer is not a measure of profit per residential customer, as DNSPs also distribute gas to commercial and industrial customers. All these customer types contribute to the revenue DNSPs collect, and to the costs of providing network services.

Due to this, a DNSP's individual customer profiles can materially influence the average profits it earns per customer.

Comparisons between DNSPs

EBIT per customer mainly differs between DNSPs due to differences in the size of their capital bases and customer numbers.

Other factors that can influence EBIT per customer should be considered when interpreting this metric, including:

- Customer profiles
- Revenue smoothing
- The effect of outturn demand differing from forecasts under weighted average price caps
- Transitional decisions and previous remittal processes, such as the 2019 JGN remittal
- Unaccounted for gas (UAFG)

Customer profiles

A DNSP's 'customer profile' refers to the composition of customers, including the type and size of customers it services.

A DNSP's customer profile may also be influenced by the geographical area it services or whether industrial customers use the gas distribution network to transport gas. We collect data on customers across the classifications of:

- Residential
- Commercial
- Industrial

Generally, different classes of customers share the costs of providing network services. This makes it difficult to isolate the costs required to serve a particular customer or group of customers. It is therefore difficult to estimate EBIT per customer for the different customer classes.

For example, when compared to residential customers, commercial and industrial users make up a small proportion of the overall customer numbers but contribute a relatively high proportion to network revenue given their higher gas consumption.

Holding other things constant, we would expect EBIT per customer for commercial and industrial users to be higher than EBIT per customer for residential customers.

Revenue Smoothing

Allowed revenues for a DNSP are calculated using the various building block costs and result in an annual revenue requirement.

These revenues are then smoothed over the access arrangement period to avoid large changes in year on year revenues. This smoothing results in a series of 'X-factors', which are a key driver of annual network revenue targets.

An impact of smoothing is the profile of target revenues over the access arrangement period often differs to what would result from the raw (unsmoothed) building blocks.

Weighted average price caps

Gas DNSPs are regulated under weighted average price caps.

Under the price cap form of control, DNSPs can earn above or below forecast revenue over time due to changes in demand. If actual demand exceeds forecast demand, DNSPs keep the higher resulting revenue. Similarly, if actual demand is less than forecast revenue, DNSPs are exposed to the shortfalls.

These higher or lower levels of demand can impact EBIT and EBIT per customer. The impact on EBIT per customer will be subdued if departures from forecast demand stem from changes in customer numbers rather than from changes in consumption across the existing customer base.

JGN transitional decision and remittal process

Analysis for JGN over the past (2014–20) and current (2020–26) access arrangement periods should be interpreted with caution.

Reported revenues for those years have not been adjusted for the following factors:

- The over-recovery of revenue over 2014 to 2020 whilst JGN sought a review of the AER's determination under the limited merits review framework.
- The downwards adjustment of $169m following the remittal process. This reduced allowed revenues for the 2020 to 2026 access arrangement period.
- The effect of multiple annual adjustments to account for movements in underlying price drivers being applied in 2020. This resulted in approximately a $26m increase to JGN's target revenue that year, which is not captured in its post-tax revenue model (PTRM) forecast.

Unaccounted for gas

DNSPs are allowed operating expenditure for UAFG. The approach to estimating this allowance varies according to the DNSP's jurisdiction.

Gas DNSPs in the ACT, NSW and SA are required to directly contract UAFG volumes. As a result, UAFG is included in their allowed operating expenditure, and therefore their revenue allowance in our access arrangement determinations.

Victorian gas DNSPs operate under a slightly different framework. The Victorian Essential Services Commission (ESCV) sets a benchmark rate of UAFG for each DNSP, measured as UAFG divided by total gas delivered. Gas retailers are required to contract sufficient gas to cover customer consumption and the actual UAFG. If actual UAFG is greater than the benchmark, the DNSP is required to compensate retailers for UAFG exceeding the benchmark.

Where actual UAFG is lower than the benchmark, retailers make reconciliation payments to the DNSP. Benchmark levels of UAFG for 2018 to 2022 can be found in the ESCV's 2017 UAFG benchmark review. Because UAFG is considered via the ESCV benchmark process, it is not considered in our access arrangement determinations, nor included in the DNSPs' operating expenditure forecasts.

How we calculate EBIT per customer

This section sets out the approach and data sources we use to calculate EBIT per customer.

The data used to calculate EBIT per customer is sourced from:

- The latest approved or proposed roll-forward models (RFMs)
- The latest approved or proposed PTRMs
- Annual regulatory information notices (RINs) reported to the AER

Revenue and expenditure

Revenue and expenditure are sourced from the income worksheet of the annual RINs. These relate to the core regulated services of the gas DNSPs, including haulage reference services and ancillary reference services.

Revenue excludes the following:

- Capital contributions: These are not included in the capital base and are therefore not used to calculate returns in the regulatory framework.
- Interest income: This is excluded as it is not part of the regulatory framework.
- Profit from the sale of fixed assets: Disposals (gross proceeds from an asset's sale) are removed from the capital base. The value of disposals in any given year is not used to calculate returns for that year and is therefore excluded from our annual calculations.

  Disposals, however, affect returns on capital in future years by reducing the net capital expenditure added to the capital base. We capture this effect by using the actual opening capital base when calculating returns.

Expenditure excludes the following:

- Finance charges: These largely comprise of interest payments on debt and are therefore excluded from EBIT per customer, which is based on EBIT.
- Impairment losses: These are not permitted by the regulatory framework.
- Loss from the sale of fixed assets: Disposals (gross proceeds from an asset's sale) are removed from the capital base. The value of disposals in any given year is not used to calculate returns that year and is therefore excluded from our annual calculations.

  Disposals, however, affect returns on capital in future years by reducing the net capital expenditure added to the capital base. We capture this effect by using the actual opening capital base when calculating returns.

Depreciation

We report depreciation using nominal straight-line depreciation, which is measured on an as-incurred basis for all DNSPs.

Depreciation is sourced from the final decision RFM where available. Where a final decision RFM is unavailable, we use the most recent access arrangement proposal or draft decision RFM.

Where those models are unavailable, we source depreciation from the PTRM. The PTRM calculates depreciation using forecast inflation. We update depreciation sourced from the PTRM using the Consumer Price Index (CPI) to reflect actual inflation where available.

Incentive scheme rewards and penalties

Our regulatory framework provides gas DNSPs with rewards or penalties through targeted incentive schemes aimed at improving network expenditure efficiency.

These schemes allow DNSPs to earn rewards (penalties) above (below) their allowed rate of return. Customers should ultimately benefit from these schemes through lower regulated prices.

EBIT per customer has been calculated both with and without incentive scheme outcomes to oberve the impact of incentives on actual returns.

For gas DNSPs, the rewards and penalties from incentive schemes have been sourced from the revenue sheet of annual RINs (table F3.6).

Customer numbers

Customer numbers for gas DNSPs are sourced from the customer number sheets (by type and tariff) of the annual RINs (tables S1.1 and S1.2)

Application of consumer price indexation

EBIT values are converted to the same dollar terms for the respective period being reported. Victorian gas DNSPs currently report on a calendar year basis, and other gas DNSPs report on a financial year basis with the end of year being 30 June.

The Victorian gas DNSPs will transition to financial year reporting at the start of their next access arrangement period (1 July 2023).

In addition, our data sources present values differently, which affects when CPI adjustments are applied. Specifically:

- Data sourced from the annual RINs apply a regulatory mid-year CPI conversion
- Data sourced from the RFMs apply a regulatory end-year CPI conversion

Annual updates

We update EBIT per customer when new RFM data becomes available where annual RIN and PTRM data had been used as a substitute.