AUSTRALIAN ENERGY REGULATOR

Explanatory note – EBIT per customer

The Australian Energy Regulator (AER) reports four regulatory profitability measures for regulated networks. We publish explanatory notes to accompany each of these measures.

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

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 an NSP's reported EBIT over the total reported number of customers who are connected to the gas distribution 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
- Customer numbers is the total number of customers who are connected to the gas distribution network in a year

How to interpret EBIT per customer

EBIT per customer is best compared against the individual NSP's past performance. 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 NSPs also distribute gas to commercial and industrial customers. All these customer types contribute to the revenue NSPs collect, and to the costs of providing network services.

Due to this, the NSP's individual customer profiles can have a significant influence on the average profits it earns per customer.

Comparisons between NSPs

Differences in EBIT per customer between NSPs are significantly explained by 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
- Weighted average price caps
- Transitional decisions and remittal processes, such as the 2019 JGN remittal
- Unaccounted for gas (UAFG)

Customer profiles

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

An NSP'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 figures for the different customer classes.

For example, when compared to residential customers, commercial or 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 an NSP are calculated using the various building block costs and result in an annual revenue requirement for the NSP.

These revenues are then smoothed over the access arrangement period to avoid significant 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 distribution NSPs are regulated under a weighted average price cap and not a revenue cap.

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

These higher or lower levels can impact the EBIT, and the EBIT per customer for each NSP.

JGN transitional decision and remittal process

Analysis for JGN over the past (2014/15 to 2019/20) and current (2020/21 to 2025/26) 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 for their 2014/15 to 2019/20 access arrangement 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 will reduce allowed revenues for the 2020/21 to 2025/2026 access arrangement.
- An annual adjustment factor, which was included in JGN's price cap to account for movements in a series of underlying price drivers. Due to the remittals, the adjustment for a number of regulatory years occurred in 2020. This resulted in approximately a $26m increase to JGN's target revenue, which is not captured in their post-tax revenue model (PTRM) forecast.

Unaccounted for gas

The allowed operating expenditure in relation to UAFG differs according to the gas distribution NSP's jurisdiction.

Gas distribution NSPs in the ACT, NSW and South Australia are required to directly contract UAFG volumes. As a result, UAFG is included in a NSP's allowed operating expenditure under our access arrangement determinations and recovered in their forecast revenue.

Victorian gas distribution NSPs operate under a slightly different framework. The Victorian Essential Services Commission (ESCV) sets a benchmark rate of UAFG for each NSP, 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 NSP is required to compensate retailers for UAFG in excess of the benchmark.

Where actual UAFG is lower than the benchmark, retailers make reconciliation payments to the NSP. 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 NSPs' 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 for an NSP is sourced from:

- The latest approved or proposed roll-forward models (RFMs) for the NSP
- The latest approved or proposed PTRMs for the NSP
- Annual regulatory information notices (RINs) reported by the NSP 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 distribution NSPs, which are haulage reference services.

Revenue excludes the following:

- Capital contributions: These are not included in the capital base and are therefore are 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 earnings before interest and tax.
- 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 have reported depreciation using nominal straight-line depreciation, which is measured on an as-incurred basis for all NSPs.

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

Where those models are unavailable, we have sourced depreciation from the PTRM.

The PTRM calculates depreciation using forecast inflation. We have updated depreciation sourced from the PTRM using the Consumer Price Index (CPI) to refelect actual inflation where available.

Incentive scheme rewards and penalties

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

These schemes allow NSPs 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 so that the impact of incentives on actual returns can be observed.

For gas NSPs, 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 distribution NSPs 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 will be converted to the same nominal dollar terms for the respective period being reported. Currently, most NSPs report on a financial year basis with the end of year being 30 June, with the exception of the Victorian gas distribution NSPs and the VTS gas transmission network.

The Victorian gas distribution NSPs 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 will update EBIT per customer annually, replacing annual RIN and PTRM data with appropriate RFM data where available.