8 February 2023

Claire Preston
Director, Network Expenditure
Australian Energy Regulator

By email: AERInquiry@aer.gov.au

Dear Ms Preston

AER review of capitalisation practices for benchmarking

CitiPower, Powercor and United Energy welcome the opportunity to provide comments on the Australian Energy Regulator's (AER's) draft decision on how it will assess the impact of capitalisation differences on benchmarking. Our businesses remain supportive of benchmarking as one of a suite of assessment tools and continue to encourage the AER to ensure its benchmarking approach is robust and fit for purpose.

Broadly, we encourage the AER to expand its benchmarking metrics to recognise the importance of customer outcomes in terms of price and service quality to improve the incentive on businesses to deliver beneficial customer outcomes.

We support the AER's draft position to address differences in capitalisation practices by allocating a fixed proportion of corporate overheads expenditure to the opex series for benchmarking purposes. This is the most economically sound option, that directly targets the most material capitalisation policy issue, which is transparent and can be implemented in a short timeframe.

It is also appropriate to apply the following methodology for implementation of this option:

- **allocate 100 per cent of corporate overheads** to the opex benchmarking series because this retains the full incentives created through benchmarking to drive efficiencies in corporate overheads. Any lesser value would diminish the incentive

- **exclude network overheads** from the opex benchmarking series because there is potential blurring between network overheads and direct costs, while there are clearer delineations between corporate overheads and network overheads. Continuing to use a frozen Cost Allocation Methodology (CAM) and the AER's definitions for expenditure allocations in the RINs will also sufficiently limit the theoretical incentive for networks to re-allocate costs to gain benchmarking advantages

- **implement a frozen 2022 CAM.** Under the AER's preferred approach, this will limit the incentives to re-allocate expenditure away from or into corporate overheads. We do however believe that the ability for DNSPs to re-allocate expenditure is limited irrespective of a frozen CAM due to accounting and audit standards for expenditure classification, which restrict a DNSPs ability to reclassify expenditure and potentially reducing the need to freeze CAMs in general.

We continue to also hold the view that the opex ratios, namely opex/totex, opex/total cost and opex/total inputs are inappropriate to use in benchmarking analysis:

- The ratios relate more to the nature of the network than they do capitalisation policies. For example, Powercor is a rural network with overhead lines that require proportionally more opex for vegetation and lines maintenance, compared to CitiPower which is predominately underground and has proportionately lower opex. This is evidenced by the difference in the ratios between CitiPower and Powercor despite both networks having identical capitalisation policies and practices.

- The ratios are likely to conflate efficiency with capitalisation practices because they cannot separately identify where a network has a high opex ratio because of its capitalisation policy or because its opex is inefficient. Therefore, any option which includes the ratios also adjusts for inefficiency of the network.

We expand on each of the key points raised below in more detail. If you have any questions regarding this submission or would like to discuss its content, please contact ███████████

Yours sincerely,
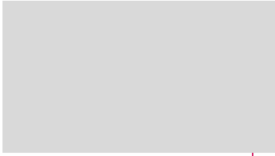
Megan Willcox
Head of Regulatory Performance & Analysis
CitiPower, Powercor and United Energy

Addressing differences in capitalisation practices by allocating a fixed proportion of overheads expenditure to the opex series for benchmarking purposes is the most appropriate approach

From an economic principle perspective, we support adjustments that address differences in capitalisation practices between networks that have an impact on benchmarking while avoiding adjusting indirectly for efficiencies. If a methodology is likely to adjust for a material level of efficiencies, this would reduce the accuracy and reliability of benchmarking models and undermine any benefits of adjusting for capitalisation practice differences.

Considering this principle, we support the AER's draft position to address differences in capitalisation practices by allocating a fixed proportion of overheads expenditure to the opex series for benchmarking purposes. This is because this adjustment is:

- **Targets the most material capitalisation policy issue** which is the material variation in proportion of corporate overheads costs to opex between networks. The catalyst for this review has been for some networks (including CitiPower and Powercor) to change capitalisation policies to expense all corporate overheads, which has been of particular concern to stakeholders. We agree with the AER that this methodology provides a high level of certainty to stakeholders because it targets known and material differences between DNSPs.

- **Economically sound** because it addresses material differences in capitalisation practices while avoiding adjusting for efficiencies. The allocation of corporate overheads would not adjust for efficiency, while conversely using opex/capex ratios would adjust for both differences in capitalisation and inefficiency.

- **Transparent** because the methodology uses publicly available RIN data to make benchmarking adjustments, creating a high degree of confidence in the replicability of the approach.

We further expand on the ideal implementation method for this approach below.

A fixed proportion of network overheads do not need to be allocated to the opex series for benchmarking purposes

We do not believe that allocating a fixed proportion of network overheads to the opex series for benchmarking purposes is necessary given the potential blurring between network overheads and direct costs, and the AER's protections in place to prevent reallocation of costs, particularly between corporate and network overheads. Specifically:

- **The potential blurring between network overheads and direct costs** lowers the effectiveness of allocating a proportion of network overheads to the opex series. This adjustment would account for network overheads but not for direct costs.

    - If there are differences in how networks allocate direct costs and network overheads, the accuracy of the adjustment would be reduced because networks would have a different proportion of direct network costs and network overheads allocated to overheads.

    - Under this approach, networks would be incentivised to allocate more costs to direct costs than to network overheads, which would then impact service delivery and deriving efficiencies.

- **There are clear delineations between what is classified as a corporate overhead and what is classified as a network overhead** in our networks. Corporate overheads are any costs incurred in the corporate business units (e.g. regulation, finance, human resources etc). Network overheads are any cost incurred in the operational business units (e.g. network planning, field services etc).

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- **The AER definitions for expenditure allocations in RINs** also restrict networks from reallocating costs between corporate overheads and network overheads, having to satisfy clearly defined AER definitions. Auditing processes also further reduce the ability to reallocate costs between corporate and network overheads because doing so must be accompanied by sound reasoning to ensure audit sign off.

- **Continuing to apply a frozen Cost Allocation Methodology** would also remove the incentive for networks to substitute expenditure between network overheads and corporate overheads to gain an advantage in benchmarking.

We note that there appears to be some variation in the proportion of corporate overheads and network overheads between networks over time. We believe that substantive business transformation programs can impact the amount of corporate and network overheads in a business. By design, transformation programs are intended to deliver overall efficiencies, and part of that efficiency gain may involve shifts between corporate and network overheads.

For example, we restructured our procurement function as part of our 'World Class' program in 2015. Procurement was previously the responsibility of various people located within multiple corporate and operational business units across the organisation. Through the restructure it was consolidated into a single procurement unit within our corporate services function. This change derived several efficiencies:

- implementing a single procurement process rather than several different ones

- making the approvals process simpler, quicker and more effective

- making it easier to share procurement knowledge between procurement specialists

- leveraging economies of scope and scale to secure lower rates.

In our experience, transformations of this nature are relatively infrequent as we have only had one major transformation over the long benchmarking period.

On balance therefore, we do not believe that a fixed proportion of network overheads needs to be allocate to the opex series for benchmarking.

The proportion of fixed corporate overheads should be 100%

We recommend that 100 per cent of corporate overheads should be allocated to the opex benchmarking series to retain the full incentive created through benchmarking to drive efficiencies in corporate overheads. Any lesser value would diminish the incentive.

The econometric approach is less preferable than adjusting the benchmarking opex series for a fixed proportion of corporate overheads

We made a follow-up submission to the AER stating that including the opex/totex and opex/total cost ratios (commonly referred to as ratios) directly into the econometric benchmarking modelling as explanatory variables was our second-preferred approach. This was on the basis that including the ratios directly within the modelling was advantageous compared to applying these ratios as an ex-post OEF adjustment, because:

- including the ratios directly in the models would allow the correlation between drivers of different ratios, such as line length and customer numbers to be considered once in the econometric modelling stage, rather than 'double-dipping' during both the econometric modelling stage and also with an ex-post OEF adjustment

- compared to an ex-post OEF adjustment, this approach would reduce the risk of the adjustments conflating efficiencies and capitalisation practices, erroneously adjusting for efficiencies (and penalising DNSPs who find efficiencies) rather than differences in capitalisation practices.

While we maintain our view that the econometric approach is preferable to an ex-post OEF adjustment, we firmly believe that allocating a fixed proportion of overheads to the benchmarking opex series is the most targeted, appropriate, robust and transparent option.

It is clear that the ratios are influenced by other factors than just overhead capitalisation policies. For example, CitiPower, Powercor and United Energy have had exactly identical overhead capitalisation policies since 2016, yet on each of the AER's three ratios, CitiPower and Powercor have very different results. These ratios are influenced by differences in network expenditure profiles, such as the efficiency of expenditure and the type of network (i.e. capex or opex driven networks due to various operating environments).

2006-2008 data should be producible in an actual or estimated capacity

We are able to produce actual overheads data back to 2006 for CitiPower and Powercor but not for United Energy. Our records for United Energy's overheads expenditure do not extend back to before our acquisition of the United Energy business. This data will need to be estimated prior to 2008, and we recommend that the AER accept actual or estimated data on overheads prior to 2008.

A frozen 2022 CAM should be used to allocate corporate overheads

We support the implementation of a frozen 2022 CAM to allocate corporate overheads to the opex benchmarking series. Under the AER's preferred approach, this will limit the incentives to re-allocate expenditure away from or into corporate overheads.

We do however believe that the ability for DNSPs to re-allocate expenditure is limited irrespective of a frozen CAM because there are accounting and audit standards for expenditure classification, restricting a DNSPs ability to reclassify expenditure and potentially reducing the need to freeze CAMs in general.

Updating the frozen CAM from 2014 to 2022 would reduce the administrative burden for networks to prepare annual opex back-casts and improve transparency of data for other networks and stakeholders.

Data transparency

We encourage the AER to investigate the robustness of anomalies in the data to ensure accuracy

It is important that the data used to inform changes to the opex data series for benchmarking purposes is accurate and robust to ensure that any adjustments to benchmarking can be confidently relied upon. Where there appear to be anomalies in the data, for example in instances where overheads are higher than opex, or where there are outliers relative to other networks, we recommend that the AER investigate the robustness of data to ensure accuracy.

We encourage the AER to maintain public visibility of the data set that it uses for its benchmarking

We have found previously that RIN data can differ to the data that the AER relies upon for benchmarking analysis, for instance because of post-RIN submission adjustments that are not published. We recognise that the AER has now published a complete and up to date data set both during its 2022 benchmarking report consultation and capitalisation practices consultation. We encourage the AER to maintain public visibility of the data set that it uses for benchmarking and the reasons for adjustments between the RIN data and the benchmark data series going forward.

It is also prudent for DNSPs to be given the opportunity to review the inaugural benchmarking report that includes the final capitalisation practices methodology changes. This will allow DNSPs to assist the AER in ensuring that the benchmarking report is as accurate and informative to stakeholders as possible.