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Arek Gulbenkoglu
General Manager, Network Expenditure
Australian Energy Regulator
GPO Box 520
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Dear Arek,

Ausgrid welcomes the opportunity to comment on the Australian Energy Regulator's (**AER**) draft guidance note on how it will assess the impact of capitalisation differences on economic benchmarking. Economic benchmarking is an important part of the regulatory framework that enables comparison of the productivity growth and efficiency of distribution network service providers (**DNSPs**) over time and compared with their peers. It directly affects the setting of regulatory opex allowances as the AER uses the results in assessing the efficiency of a DNSP's base opex and whether an efficiency adjustment is required. We therefore appreciate and support the AER's efforts to continually improve the benchmarking framework.

We agree with the AER's findings that there are material differences in capitalisation practices among DNSPs. We also agree that these differences are having a material impact on the comparability of data used for benchmarking and the benchmarking results.

As previously submitted, we do not support ex-post operating environment factor (**OEF**) modelling adjustments for capitalisation differences using selected opex/capital ratios. We raised concerns with the appropriateness of the ratios, the variability and wide range of potential OEFs given different time periods and ratio weightings. While ex-post OEF adjustments remain an option for consultation, we are pleased to note that the AER has moved away from this option as its preferred approach. From the draft guidance note, the AER's preference is to now adjust the opex used for benchmarking by allocating a fixed proportion of overheads expenditure. Under this option, the AER has also indicated its preference to allocate 100% of corporate overheads to opex for benchmarking.

We continue to consider that incorporating an explanatory variable to the econometric opex cost function modelling that directly captures capitalisation differences is conceptually the better approach to directly adjusting for capitalisation differences. However, we now appreciate, based on the AER's further investigations of this option, that data availability and data comparability particularly for non-Australian networks, does not make this option feasible, at least at this time. Given the practical challenges of pursuing this option in the short-term, we support as our next preferred option, adjustments to data pre-modelling to normalise opex for material differences in capitalisation practices among businesses.

We agree that differences in the capitalisation of corporate overheads accounts for a major source of these differences. Since the start of the AER’s opex benchmarking in 2014, some DNSPs have changed their cost allocation methodologies (**CAMs**) to expense 100% of their corporate overheads, and yet continue to be benchmarked according to their 2014 frozen CAMs. This provides these businesses with a material advantage over their peers in benchmarking. Normalising opex by allocating 100% of corporate overheads to the opex series for benchmarking will not only address a significant issue with the use of frozen CAMs, it also brings into line the opex used in benchmarking with actual reported opex for many businesses. Acknowledging that not all businesses expense their corporate overheads, taking this approach for the purpose of opex benchmarking addresses a material source of capitalisation differences between businesses, that is currently not reflected in the benchmarking results.

Set out in the attachment to this submission are our considerations of and responses to the implementation issues that the AER is seeking feedback on. If you have any questions regarding this submission, please contact Fiona McAnally ([redacted] or [redacted]

Regards,

[redacted]

Alex McPherson
Head of Regulation

**Attachment – Responses to implementation issues with the AER's preferred option**

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| 1. Which CAM basis to use for the benchmarking opex series | Ausgrid considers that allocating 100% of corporate overheads to the opex series based on frozen 2014 CAMs will significantly address concerns we have raised in past submissions regarding the use of frozen CAMs for benchmarking. Since this approach approximates current practices by some businesses to expense their corporate overheads, we consider that refreezing CAMs to the current CAM will not be necessary.<br><br>Not only does back casting of historical opex based on a refrozen 2022 CAM create additional work and reporting burden on businesses that have changed their CAMs, it could also only be a short-term solution until the next round of CAM changes by other businesses and a refreezing to a new set point is required.<br><br>We understand and support the AER's intention of using frozen CAMs to maximise the comparability of opex for a given DNSP over time. In our view, the use of the 2014 CAMs in conjunction with the allocation of 100% corporate overheads to the opex for benchmarking is the simplest, most transparent and practical method of implementing the AER's preferred option. |
| 2. The allocation to opex of corporate overheads versus total overheads | We support the AER's preference to adjust only for corporate overheads rather than total corporate and network overheads. We agree that corporate overheads are relatively homogeneous across DNSPs and therefore can be clearly separated from network cost categories. The changes made by relevant DNSPs to their CAMs since the start of benchmarking, also largely affected only the treatment of corporate overheads, lending support to the AER's preferred implementation of this option.<br><br>We do not consider that a similar clear case applies to network overheads. There is no visibility and insight from reported data as to what costs DNSPs may include as network overheads versus direct costs. For example, one DNSP may charge network fleet costs directly against operating and capital projects while another may treat these costs as a network overhead cost pool that is allocated out to projects. Differences in outsourcing vs insourcing of network support activities will also affect whether costs are treated as direct costs or network overheads. In contrast, corporate support activities are generally of similar nature and treated as corporate overheads, whether delivered internally or outsourced.<br><br>An additional consideration is that to the extent network overheads are variable, the capitalisation of network overheads is driven by factors including differences in the investment and asset replacement cycles |

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| | of DNSPs and forecast growth in their networks. As a result, the significant variations in capital spending across businesses will influence the level of capitalised network overheads over time that are unrelated to opex efficiency. In contrast, corporate overheads, are generally less elastic to changes in a DNSP's capital works program.<br><br>These considerations make comparisons of network overheads across DNSPs less suitable, relative to those for corporate overheads.<br><br>Regarding the potential for businesses to materially reallocate costs from corporate to network overheads, we agree that the AER monitoring the data they collect annually from businesses through the Regulatory Information Notice process is an appropriate deterrent. Any material reallocations from corporate to network overheads in an attempt to improve benchmarking scores should be investigated. |
| 3. The percentage of capitalised overheads to be allocated to opex for benchmarking purposes | We support the allocation of 100% of corporate overheads to opex for its simplicity. This is the most practical approach given that many DNSPs have moved to expense 100% of their corporate overhead costs and therefore should bring all DNSPs to an equal footing, for benchmarking purposes. |
| 4. When and how to commence the opex series for benchmarking | To avoid data estimation and data reliability issues associated with estimating and providing overhead costs for historical years, our preference is for the AER to make 2009 the new start point of the long benchmarking period. For comparability across previous benchmarking, we support retaining 2012 as the start of the short benchmarking period.<br><br>We consider this to be simplest and most practical implementation approach without associated data estimation issues. |
| 5. Efficiency assessments in revenue determinations | For consistency, we agree that capitalised corporate overheads should be added to base year opex in the assessment against modelled efficient opex.<br><br>We also do not see any inconsistency between incorporating capitalised corporate overheads within the opex benchmarking approach and the AER's standard capitalised overheads forecasting approach in regulatory resets. |