AER 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 per interest and tax (EBIT) per customer for the electricity network service providers (NSPs). It also explains what factors to consider when interpreting these ratios. 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 connected to the 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 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 varies with the NSP's energy source and sector. The source of the customer numbers is provided below.

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 regulatory asset base (RAB) or allowed returns.

EBIT per customer is not a measure of profit per residential customer, as NSPs also provide energy 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 materially affect the average profits it earns per customer.

Comparisons between NSPs

Differences in EBIT per customer between NSPs are largely explained by the size of their RABs and customer numbers.

Other factors that can influence EBIT per customer include strong NSP performance under incentive schemes and against allowances. Differences in EBIT per customer can also be driven by the following factors discussed below:

- Customer profiles
- Revenue smoothing
- Unders and overs arrangements
- Cost pass through and other pass through events
- Jurisdictional factors, such as remittals, solar bonus schemes and feed-in tariffs.

Customer profiles

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

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A NSP's customer profile may be influenced by the geographical area it services as this can determine network size, topology, and customer density. We collect data on customers across the classifications of:

- Residential
- Small commercial
- Large scale commercial and 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, small or medium enterprise (SMEs) or large scale industrial users make up a small proportion of overall customer numbers but contribute a relatively high proportion to network revenue given their higher energy needs.

Holding other things constant, we would expect EBIT per customer for SMEs and large 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 regulatory period to avoid large changes in yearly revenues. This smoothing results in a series of 'X–factors', which are a key driver of annual network revenue targets.

After smoothing, the profile of target revenues over the regulatory period is often different to what would result from the raw (unsmoothed) building blocks.

Unders and overs arrangements

NSPs operating under a revenue cap may recover above or below their allowed revenue target in a given year due to differences between forecast and actual demand. The unders and overs arrangement adjusts for any over or under spends in subsequent years so NSPs recover their allowed revenue in net present value terms over time.

Cost pass through events

A cost pass through mechanism recognises that an NSP may be exposed to material cost changes beyond its control. Cost pass through events, when approved, allow an NSP to recover costs that were not built into its revenue determination, or return costs that no longer need to be built in.

Other pass through events

Electricity distribution NSPs are also required to recover other pass through revenues, including revenue earnt on behalf of transmission NSPs and revenue related to jurisdictional schemes.

A distribution NSP may under or over recover revenues for these pass throughs in a given year, resulting in its returns deviating from allowances. It must therefore operate an unders and overs account for both the transmission and jurisdictional scheme revenues. This means the NSP recovers its allowed revenue in net present value terms over time.

The financial performance dataset includes an option to calculate an NSP's EBIT per customer inclusive or exclusive of pass through revenues.

NSW/ACT transitional decision and remittal

Analysis of the NSW/ACT electricity distribution NSPs over the 2014–2019 regulatory period should be interpreted with caution. Reported revenues for those years are not adjusted for:

- The transitional decision in 2015, which set a higher revenue target for that year than in the final regulatory determination. Revenues recovered in regulatory year 2015 were therefore materially higher than in the final decision. The NSPs returned their over recovered revenue to customers over the rest of the regulatory period.

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- Our 2014–19 regulatory determinations, which NSPs appealed and were set aside. During the appeal period, we accepted undertakings by NSPs setting out how they would recover revenues for regulatory years 2017–2019. These undertakings resulted in NSPs collecting more revenue than what the final remittal decision provided. These NSPs are returning revenue over recovered from this process to customers in the 2019–25 regulatory period.

Queensland solar bonus scheme

During the 2010–15 regulatory period for Energex and Ergon Energy, we included forecast solar bonus scheme payments in the opex allowance. We included a pass through mechanism for any difference to be applied two years later during the annual pricing process. Uptake of this scheme materially exceeded forecasts. This resulted in large under recoveries during regulatory years 2014 and 2015, which were recovered through higher revenue targets in 2016 and 2017. In the 2015–20 regulatory period, further solar bonus scheme amounts were recovered through a jurisdictional scheme obligation, which fed into distribution charges as part of the annual pricing process.

Due to the changing treatment of this scheme, the switch in our model to remove pass through events does not 'zero out' the scheme's specific impacts as applied in the 2010–15 regulatory period. Returns in the 2014 and 2015 regulatory years therefore appear lower than they otherwise would, and returns in 2016 and 2017 appear higher than they otherwise would.

ACT Government's feed-in tariffs for large scale renewable energy generation

Evoenergy must apply to the ACT Government to recover reasonable costs in relation to the feed-in tariff for large scale renewable energy generation. As application occurs in the middle of the regulatory year, Evoenergy must use forecasts rather than actual expenditure. This

can result in large over or under recoveries of jurisdictional revenue.

Due to this, there have been substantial over recoveries of jurisdictional revenue in regulatory years 2018, 2019 and 2020, and a substantial under recovery in 2021.

As a result, when determining EBIT per customer inclusive of jurisdictional schemes, returns in regulatory years 2018 and 2019 appear higher than they otherwise would, and returns in 2020 and 2021 appear lower than they otherwise would.

How we calculate EBIT per customer

This section sets out our approach and data sources for calculating EBIT per customer. We source data for calculating EBIT per customer from:

- The latest approved or proposed roll-forward models (RFMs) for the NSP

- The latest approved or proposed post-tax revenue models (PTRMs) for the NSP

- The NSP's annual data submissions, including through regulatory information notices (RINs)

Revenue and expenditure

For electricity distribution NSPs, we source revenue and expenditure data from the income worksheet of the annual reporting RINs. For electricity transmission NSPs, we source that data from the disaggregated income statement of the annual regulatory accounts.

This data only relates to core regulated services for electricity NSPs, which are:

- Standard control services for distribution

- Prescribed transmission services for transmission

Revenue excludes the following:

- Capital contributions: These are not included in the RAB and are not used in to calculate returns in the regulatory framework.

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- 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 RAB. 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 net capex added to the RAB. We capture this effect by using the actual opening RAB as the basis for calculating returns.

Expenditure excludes the following:

- Finance charges: These largely comprise interest payments on debt and are therefore excluded from ROA, which is based on EBIT.

- Impairment losses: These not permitted by the regulatory framework.

- Losses from the sale of fixed assets: These are excluded as the NSP is compensated through return of capital (depreciation).

Distribution NSPs, Ausgrid and Evoenergy are owners of dual function assets. These assets operate in parallel with TransGrid's transmission network and essentially perform a transmission function by supporting the main NSW transmission network.

Revenue and expenditure associated with dual function assets are treated as standard control services for the relevant distribution NSPs.

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 this is unavailable, we use the most recent regulatory proposal or draft decision RFM. Where those models are unavailable, we source depreciation from the NSP's PTRM, updated for the Consumer Price Index (CPI) to reflect inflation.

Incentive scheme rewards and penalties

Our regulatory framework provides NSPs with rewards or penalties through targeted incentive schemes aimed at improving network efficiency and reliability. 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 and improved reliability.

We have calculated EBIT per customer both with and without incentive scheme outcomes to show the impact of incentives on actual returns.

The rewards and penalties from incentive schemes has been sourced from the revenue sheet of the Economic Benchmarking RIN (table 3.1.3).

Annual updates

We will update EBIT per customer annually, using appropriate RFM data where available.

Customer Numbers

We source customer numbers from different datasets, according to their sector:

- Distribution NSPs: The STPIS reliability sheet of the Annual Reporting RIN (table 6.2.4).

- Transmission NSPs: Adding customer numbers from the distribution NSPs connected to the electricity transmission network in the same jurisdiction; and customers connected directly to the transmission network (direct connections points). We source this data from the operational data worksheet of the Economic Benchmarking RIN (table 3.4.2).