

14 February 2023

Mr Arek Gulbenkoglou
General Manager Network Expenditure
Australian Energy Regulator (AER)
GPO Box 520
Melbourne VIC 3001

Dear Gulbenkoglou,

AER DRAFT GUIDANCE NOTE: HOW THE AER WILL ASSESS THE IMPACT OF CAPITALISATION DIFFERENCES ON OUR BENCHMARKING

Endeavour Energy appreciates the opportunity to provide feedback to the AER's draft guidance note on accounting for the impact of different capitalisation practices in its benchmarking.

We welcome the AER's decision to depart from its initial preferred view that opex/capital ratios could be used to inform a capitalisation Operating Environment Factor (OEF) adjustment in favour of allocating corporate overheads expenditure to the benchmarking opex series. The allocation of corporate overheads is the most material and pressing issue driving differences in capitalisation approaches and we consider Option 5 offers a relatively simple way to address the issue of non-efficiency related variability in benchmarking results.

In our response to the consultation paper, we stated our general preference is for the impact of capitalisation differences to be accounted for within the econometric benchmarking models (Option 2) thereby removing the need for data normalisation or post-modelling adjustments. However, we accept that significant data challenges which the AER has limited ability to resolve make the introduction of a capitalisation explanatory variable complex and problematic.

Specifically, we are satisfied that the AER has demonstrated there are endogeneity issues with using opex/capital ratios within the model specification and inconsistencies in the international dataset which lack the reliability and robustness needed to make Option 2 workable.

We acknowledge the analysis undertaken by the AER and the detailed consideration of stakeholder feedback to inform their preferred approach to what is a relatively complex issue. Although each option considered by the AER has various strengths and weaknesses, on balance we agree that the preferred approach would best satisfy the assessment criteria.

Use of opex/capital ratios

Consistent with the feedback from most stakeholders, we continue to hold reservations about the AER's use of opex/capital ratios to apply a capitalisation OEF adjustment to a DNSP's efficiency score (Options 1 and 3). In our view, there is no clear evidence to suggest these ratios - collectively or in isolation - are sufficiently representative of the capitalisation differences between DNSPs. As a high-level gauge of capitalisation practices, the ratios are useful for evaluating the materiality of the capitalisation differences between DNSPs. For other more deterministic purposes, they should be interpreted with a high degree of caution.

Underpinning our view that the ratios are not sufficiently robust and fit-for-purpose to inform an OEF adjustment is the fact that the ratios are sensitive to a variety of factors (e.g. opex/capex trade-offs, asset

replacement cycles etc.) unrelated to capitalisation and therefore capture the impact of factors irrelevant to the assessment of opex efficiency.

We have also performed analysis which reveals significant variation between the opex/capital ratios and capitalised overheads for most DNSPs, suggesting there is limited correlation between opex/capital ratios and capitalisation policies. Furthermore, we identified examples of significant variation in annual opex/totex ratios for individual DNSP (including Endeavour Energy) despite most DNSPs not having changed their Cost Allocation Method (CAM) since 2014.

Intuitively, volatility in measures reflecting capitalisation practices would not be reasonably expected where a DNSP has maintained a consistent capitalisation policy. Rather, this volatility is likely explained by the presence of factors unrelated to capitalisation and means opex/totex ratios are also incongruously sensitive to the averaging period selected to derive an OEF adjustment.

We note the propensity for the ratios to capture non-capitalisation factors has contributed to the AER loss of confidence in the appropriateness of this option. The AER has also acknowledged that the econometric models already implicitly capture opex/capital aspects of capitalisation practices to some but varying extent through the existing output variables, which are highly correlated with a capital input variable. In our view, this observation means it fails the non-duplication criterion required of all prospective OEF candidates and raises eligibility doubts.

In relation to Option 4, the use of opex/capital ratios to derive a common opex/capital ratio that would apply to all DNSPs as a pre-modelling benchmarking opex adjustment also limits the appeal of this approach. In this sense, it performs poorly against the validity/fit-for-purpose and accuracy/reliability assessment criteria.

Allocating corporate overheads to opex

Option 5 involves allocating corporate overheads (expensed and capitalised) to the benchmarking opex series. This is now the AER's preferred option largely because it takes into account a known, measurable and material key difference in capitalisation practices between DNSPs. This is reflected in the changes in the accounting treatment of corporate overheads which underpins the majority of changes which have been made to Cost Allocation Methods (CAM) since 2014.

We support a 100% allocation on the basis that it would better address the core issue of data consistency and comparability relative to a lower and more conservative allocation. Furthermore, total corporate overheads are generally not directly related to the management and operation of field resources and has a low correlation to the underlying network and variability in capital investment programs. They are relatively fixed and reflect the statutory obligations and service levels that the DNSP must operate within. Broadly, corporate overheads have recurrent opex-like characteristics which further supports their inclusion within the benchmarking opex series.

We agree the main appeal of standardising the treatment of corporate overheads relates firstly to the high level of confidence that the primary driver of capitalisation difference is being addressed. It also limits inadvertently accounting for factors that are either not related to capitalisation practices or are already accounted for elsewhere in the AER's benchmarking. These features are largely absent among the other considered options.

Nevertheless, a perceived weakness of this option is that the resulting benchmarking opex will not accurately reflect a DNSP's actual cost allocation practices. We note this shortcoming is shared by other options to varying degrees and is an unavoidable consequence of any data normalising or standardisation measure. We consider issues from imposing uniformity in corporate overhead practices for opex benchmarking purposes is outweighed by the benefit from allowing comparability between DNSPs to be improved.

Another potential issue is that the approach accounts for the main, but not all potential sources of capitalisation differences between DNSPs, namely network overheads. This raises the concern that by not also including network overheads in the opex series, an incentive for DNSPs to reallocate corporate overheads to network overheads may arise.

This incentive could be tempered through the limited discretion DNSPs generally have over the treatment of network overheads relative to corporate overheads as the ability to reallocate costs to network overheads (particularly capitalised network overheads) is constrained by financial standards and accounting conventions. Also, any incentive for DNSPs to strategically and subsequently shift costs between corporate and network overheads for benchmarking gains would be largely mitigated where benchmarking opex is reported by reference to a frozen CAM as per the AER's preferred approach. This is because the benefit from reallocating corporate overheads elsewhere would not be reflected in benchmarking results.

We also note the regulatory framework has safeguards to protect against DNSPs from gaming capitalisation or cost allocation practices to achieve favourable benchmarking outcomes. For instance, the AER reviews and approves any changes to a network's CAM and has the ability to interrogate changes to capitalisation practices. The AER also has significant information gathering powers and oversight that would allow it to identify instances where cost shifting might be occurring.

Specifically, the cost information collected through the RINs would equip the AER with the ability to monitor whether there are any such changes and seek to understand the basis for these, including whether they are motivated by benchmarking performance. Over time, where this information reveals that cost shifting is prevalent and there is evidence network overheads are contributing to the difference in capitalisation practices between DNSPs, the inclusion of network overheads in the opex benchmarking series may be justified.

Freezing current (2022) CAMs

The main rationale for freezing CAMs at a point-in-time is to prevent opex benchmarking improvements from reallocating costs from opex to capex which in reality does not represent an efficiency gain. It also prevents breaks in the opex series that would otherwise occur as a result of a CAM change, making it difficult to determine whether efficiency or accounting change is driving a DNSPs benchmarking performance.

Inconsistency in the opex series is not addressed by allocating 100% of corporate overheads to opex and therefore freezing the CAM is required to provide time series comparability and continuity in benchmarking opex. In relation to benchmarking gains from allocating opex to capex, attributing all corporate overheads to the benchmarking opex series does limit the incentive for DNSPs to strategically change their CAMs. However, this is confined to corporate overheads and to the extent that there are opportunities in other expenditure categories to shift costs from opex to capex to achieve favourable benchmarking outcomes, it may not deter DNSPs from doing so.

We therefore agree with the AER that continuing to use a frozen set of CAMs for benchmarking limits the incentive for other sources of accounting policy differences to emerge, thus minimising the opportunity to benefit from strategic CAM updates and maximising like-with-like comparability over time.

Having established a preference for a frozen CAM, we believe there is merit in the AER freezing the current set of CAMs. This preference stems from our previous criticisms of the AER's use of frozen 2014 CAMs which has meant that DNSPs have been benchmarked on opex derived from increasingly outdated accounting approaches that are no longer representative of their current corporate structures and cost allocation practices. Critically, even though most DNSPs have not revised their CAMs, DNSPs are benchmarked on their relative performance meaning all DNSPs have been impacted by each CAM change.

Other weaknesses of continuing to use 2014 CAMs include:

- a growing divergence between the CAMs used for setting opex allowances and the CAMs used to assess the efficiency of opex via the benchmarking
- poor transparency leading to potential for misleading impression that actual opex is being benchmarked rather than opex based on 2014 CAMs
- it may create the incentive to revise CAMs to allocate more expenditure to opex, as this opex will not be captured under the AER's benchmarking.

We are cognisant that eventually, re-freezing the current CAMs may also be vulnerable to these same weaknesses and as DNSPs CAMs continue to change over time, face the issue that the CAMs used for benchmarking purposes diverges from those used for reported opex. That is, although freezing current CAMs is better justified than persisting with the 2014 CAMs and better satisfies the validity and accuracy criteria, the relative merits of this approach will gradually decline.

It may therefore be appropriate for the AER to revisit this issue to determine whether a refreeze of the benchmarking opex series is required. Alternatively, the AER could introduce an arrangement that would allow it to automatically apply a CAM refreeze at a pre-determined but infrequent time interval that is triggered irrespective of the number and effect of CAM changes made during the intervening period.

If you have any queries or wish to discuss our submission further please contact [REDACTED]
[REDACTED]

Yours sincerely,

[REDACTED]

[REDACTED]
[REDACTED]