EBIT PER CUSTOMER

Explanatory Note

This note explains our approach to report on EBIT per Customer for the network service providers (NSP or NSPs) we regulate as well as factors that should be taken into consideration when interpreting these ratios. This note discusses:

- *What is EBIT per customer*
- *Notes on interpreting EBIT per customer*
- *How we calculate EBIT per customer*

What is EBIT per customer?

EBIT per customer is a simple ratio of a NSP's reported net earnings before interest and tax expense (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
- The customer numbers are dependent on the energy source and energy sector of the NSP. The source of the customer numbers is provided below.

Notes on interpreting 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 return outcomes such as the regulatory asset base, allowed returns or both.

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 have a significant influence on the average profits it earns per customer.

Comparisons between networks

Differences in a given year in EBIT per customer between NSPs are significantly explained by the size of the NSPs' Regulatory Asset Bases (RAB) and the number of customers they serve.

In addition, there are a number of other factors that can influence the variance of EBIT per customer results.

These factors should be taken into consideration when interpreting EBIT per customer results:

- Customer profiles
- Revenue smoothing
- Unders and overs arrangements
- Cost pass-through events
- Other pass-through events
- NSW/ACT transitional decisions and remittal processes

Customer profiles

By describing an NSP's 'customer profile' we refer to the composition of customers including the type and size serviced by a network.

A NSP's customer profile may be influenced by the geographical area that it services that determines network size and 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 users 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.

Therefore it is difficult to estimate EBIT per customer figures for the different customer classes.

For example, when compared to residential customers, a small or medium enterprise (SMEs) or large scale industrial user 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 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.

The impact of smoothing is that the profile of target revenues over the regulatory period is often different to that which would have resulted from the raw (unsmoothed) building blocks.

Unders and over arrangements

A NSP operating under revenue cap regulation may recover more or less than its allowed revenue target in any given year, due to differences between forecast and actual demand.

This difference is adjusted for through the revenue cap unders and overs arrangement, and returned to customers in subsequent years.

Over time this means that a NSP can never recover more or less revenue than allowed in net present value terms.

Cost pass-through events

Pass-through events are considered during a NSPs determination.

A cost pass-through mechanism recognises that an NSP may be exposed to costs that are beyond its control. Cost pass-through events, when approved, allow NSPs to recover costs that are not built into its revenue determination.

Not all cost pass-throughs lead to higher prices for consumers. In some instances incurred costs are lower than forecast, meaning revenues must be returned to customers in subsequent years.

Other pass-through events

An electricity distribution NSP is required to recover other pass-through revenues including revenue collected on behalf of transmission NSPs and revenue related to Jurisdictional schemes.

An electricity distribution NSP may under or over recover revenues for these pass-throughs in any given year, resulting in deviations in its returns against allowances.

An electricity distribution NSP must operate an unders and overs account for both the transmission and Jurisdictional scheme revenues. This means that an electricity distribution NSP can never recover more or less revenue than allowed in net present value terms.

NSW/ACT transitional decision and remittal process

Analysis for the NSW/ACT electricity distribution NSP's 2014/15 - 2018/19 regulatory periods should be interpreted with caution. Reported revenues for those years have not been adjusted for:

- The transitional decision in 2014/15, which set a higher revenue target for that year compared to the final regulatory determination.

  As a result, revenues recovered in 2014/15 were materially higher than the final decision. This over recovery was returned to customers throughout the remainder of the regulatory period.

- Our 2014/15 - 2018/19 regulatory determinations final decisions, which NSPs appealed and were subsequently set aside.

  During the period of appeal we accepted undertakings given by NSPs that set out how they would recover revenues for years 2016/17 - 2018/19. These undertakings resulted in revenue collection in excess of our final remittal decision for some NSPs.

  Any over recoveries arising from the undertaking process will be returned to customers in the 2019/20 - 2024/25 regulatory period.

How we calculate EBIT per customer

This section sets out the approach and data sources we used to calculate EBIT per customer.

The data used to calculate EBIT per customer is sourced from the following sources:

- 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.
- Annual submissions reported by the NSPs to the AER.

Revenue and expenditure

Revenues and expenditures are sourced from the income worksheet of the annual reporting regulatory information notices (RINs) (electricity distribution NSPs and gas NSPs) and the disaggregated income statement of the annual regulatory accounts (transmission NSPs).

This relates to the core regulated services of the NSP. These are:

- Standard control services for electricity distribution NSPs
- Prescribed transmission services for transmission NSPs
- Haulage reference services for gas distribution NSPs
- Reference services and other services provided as a covered pipeline for gas transmission NSPs.

Revenue excludes capital contributions, interest income and profit from the sale of fixed assets.

- Capital contributions are not included in the RAB and are therefore are not used in the calculation of returns in the regulatory framework.
- Interest income is excluded as it is not part of the regulatory framework.
- Disposals (gross proceeds from an asset's sale) are removed from the RAB. The value of disposals in any given year is not used in the calculation of returns in that same year and is therefore excluded from our annual calculations. Disposals do impact returns on capital in *future* years by reducing net capex additions to the RAB. We capture this effect through the use of the actual opening RAB as the basis for calculating returns.

Expenditure excludes finance charges, impairment losses and loss from the sale of fixed assets.

- Finance charges largely comprise interest payments on debt and therefore excluded as the ROA calculation is based on earnings before interest and tax.
- Impairment losses are excluded as they are not permitted by the regulatory framework.
- Disposals (gross proceeds from an asset's sale) are removed from the RAB. The value of disposals in any given year is not used in the calculation of returns in that same year and is therefore excluded from our annual calculations. Disposals do impact returns on capital in *future* years by reducing net capex additions to the RAB. We capture this effect through the use of the actual opening RAB as the basis for calculating returns.

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

The revenues and expenditures associated with the operation of dual function assets have been included in the standard control services for the relevant electricity 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 a final decision RFM is unavailable we have used the most recent regulatory proposal or draft decision RFM.

Where those models are unavailable, for electricity distribution NSPs we have sourced depreciation from the annual economic benchmarking RIN.

For electricity transmission NSPs, where an RFM is unavailable we have sourced depreciation from the PTRM. This allows us to consistently report nominal straight-line depreciation on an as-incurred basis.

The PTRM calculates depreciation using forecast inflation. We have updated depreciation sourced from the PTRM using actual inflation where available.

For gas distribution and transmission NSPs we will determine the source of the data when historical data is reported by these NSPs in November 2020.

Customer Numbers

Customer numbers are sourced for different sources according to the energy source and sector:

Electricity	
Distribution	The STPIS reliability sheet of the Annual Reporting RIN (table 6.2.4).
Transmission	• The aggregate of the customer numbers from the electricity distribution NSPs connected to the electricity transmission network operating in the same jurisdiction; and • Directly connected electricity transmission network customers (direct connections points) which are sourced from the operational data worksheet of the Economic Benchmarking RIN (table 3.4.2).
Gas	
Distribution	The customer number sheets (by type and tariff) of the Annual Reporting RIN (tables S1.1 and S1.2)
Transmission	We do not report on EBIT per customer for gas TNSPs due to data limitations. Further details are provided in our final position paper on the profitability measures.

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 end of year being 30 June, with the exception of the Victorian electricity distribution NSPs and the AusNet electricity transmission network.

The Victorian distribution NSPs will transition from calendar year to financial year reporting at the start of their next regulatory period (1 July 2021).

In addition, our data sources report values differently affecting the timing of consumer price indexation (CPI) adjustments.

- Data sourced from economic benchmark RINs, annual reporting RINs and regulatory accounts are applied with a regulatory mid-year CPI conversion.
- Data sourced from the Roll Forwards Models (RFMs) are applied with a regulatory end-year CPI conversion.

Incentive scheme rewards and penalties

Our regulatory framework provides NSP's 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.

The EBIT per customer measure has been calculated both with and without incentive scheme outcomes so that the impact of incentives on actual returns can be observed.

The rewards and penalties from incentive schemes has been sourced from:

- For electricity NSPs the revenue sheet of the Economic Benchmarking Regulatory Information Notice (RIN) (table 3.1.3).
- For gas NSPs the revenue sheet of the Annual Reporting RIN (table F3.6).

Annual updates

We will update EBIT per customer annually, replacing economic benchmarking RIN and PTRM data with appropriate RFM data where available.