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By email: AERInquiry@aer.gov.au

12 August 2022

Dear Sebastian

Submission on the capitalisation operating environment factor

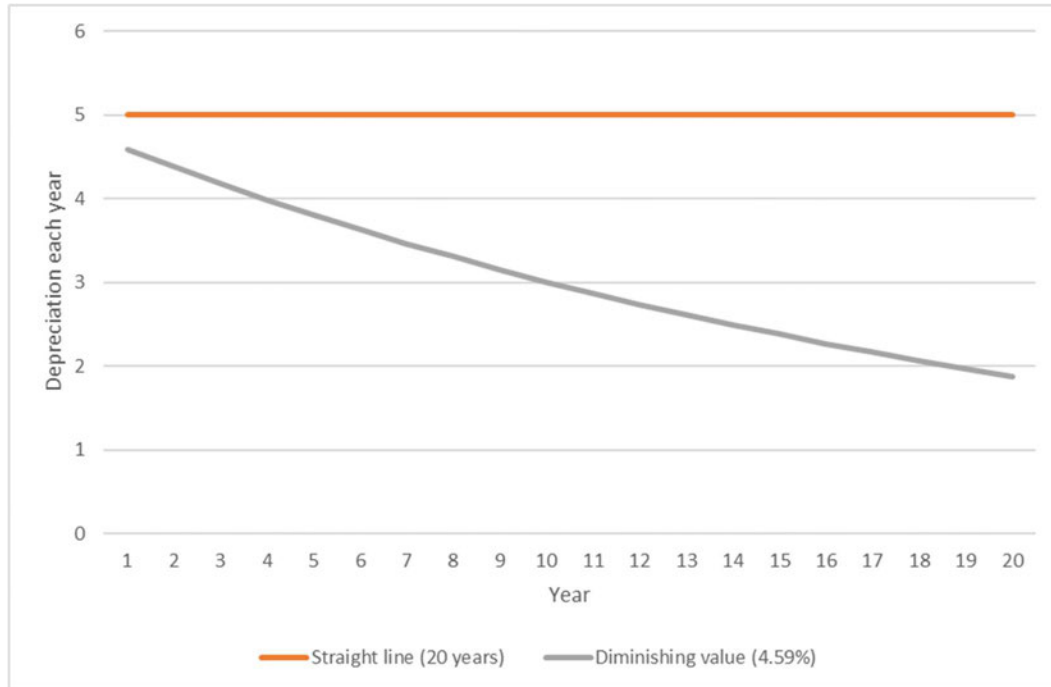
Jemena Electricity Networks (Vic) Ltd (**JEN**) welcomes the opportunity to respond to submissions that advocate adding an explanatory variable to the econometric benchmarking models to directly capture capitalisation practices instead of adopting the AER's current approach of applying post-modelling adjustments. In assessing this approach, we consider it important to understand whether the international dataset (relied on) is consistent and comparable to Australian distribution network service providers (**DNSPs**).

We have reviewed the international data and have concerns with the significant differences in the calculation of capex and annual user cost (**AUC**) between Australian, New Zealand and Ontario DNSPs. We elaborate on our concerns below.

1. Depreciation method – Australian and New Zealand DNSPs depreciate assets on a straight-line basis, with asset lives differing depending on the mix of assets. Ontario DNSPs—on the other hand—adopt a diminishing value depreciation profile (4.59% p.a.) across all capex with no distinction between asset classes. This means that depreciation could be very different between Australian and Ontarian electricity distribution businesses, even if they have an identical RAB value and asset mix.

The stylised example—outlined in figure 1 below—shows the amount depreciated each year under a 4.59% diminishing value depreciation profile compared to a straight-line depreciation profile with a 20-year asset life (historical cost assumed to be \$100). Under a straight-line depreciation profile, the amount depreciated is constant at \$5. However, under a diminishing value depreciation profile, the amount decreases from \$4.6 in year 1 to \$1.9 in year 20.

Figure 1 – Depreciation profile



It follows that, under the AER and NZ systems, firms with different time profiles of investment will have different depreciation rates – even if their total value of assets is the same. For Ontario businesses, electricity distribution businesses will have the same depreciation rate.

- 2. Quality of capex information** – Ontario Energy Board’s data for the years prior to 2013 does not include actual capex; instead, it relies on estimated capex and asset base. This capex is estimated/approximated by a change in gross plant value with some assumed adjustments to capture the renewal of retired assets. This data based on estimated capex is inconsistent with AER’s use of actual audited capex.
- 3. Capex categories for benchmarking** – The AER’s benchmarking excludes capex from Alternate Control Services (metering and public lighting), connection services, and ‘the first stage of two-stage transformers’. It is unclear whether Ontarian and New Zealand DNSPs’ capex excludes these categories.

The above data issues need to be appropriately assessed before the models are changed to internalise capitalisation differences. In addition to the above data issues, we also observe a much larger dispersion in the opex to capital ratios of international DNSPs compared to Australian electricity distribution businesses, as presented in the two charts below.

Figure 2 – Opex/AUC dispersion comparison

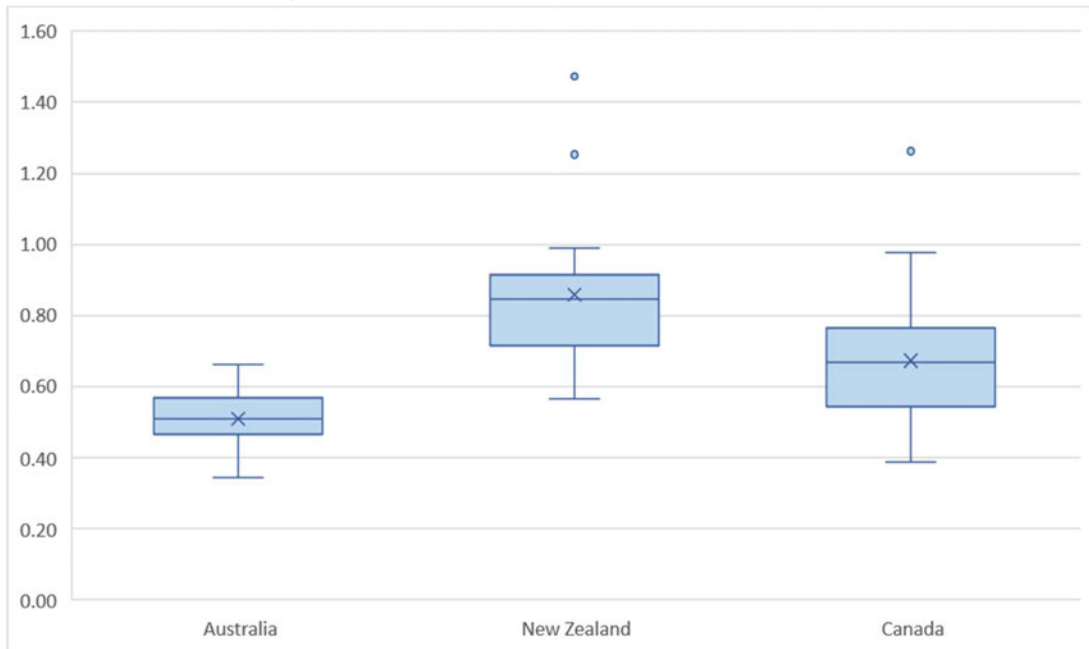


Figure 3 – Opex/capex dispersion comparison

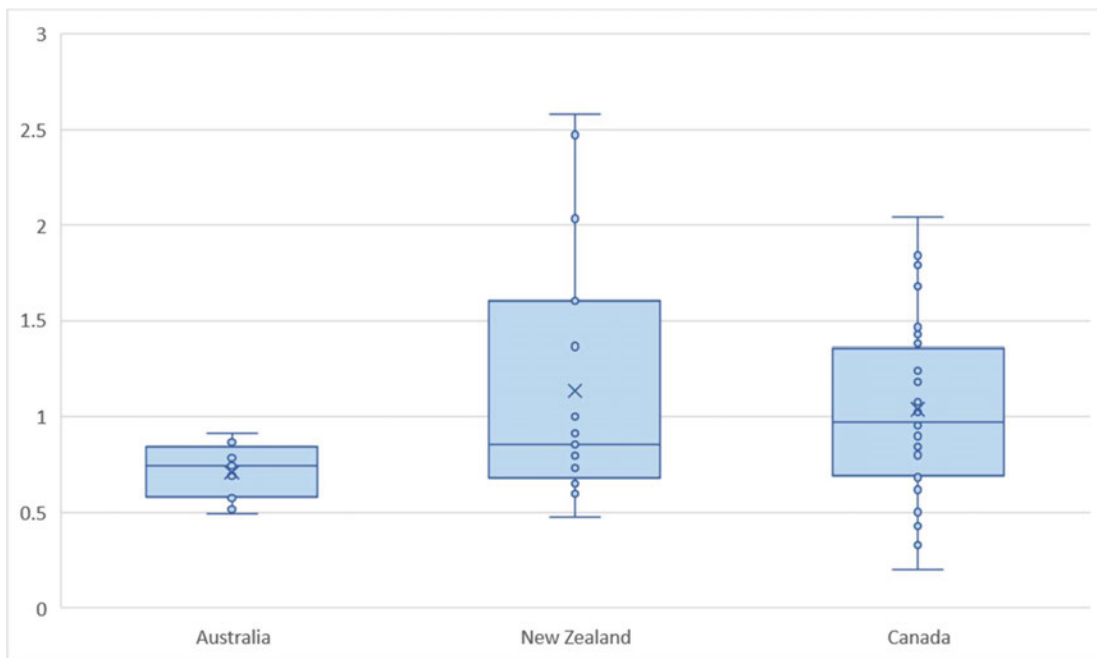


Chart note: The box shows the range between 25th to the 75th percentile of the distribution (inter-quartile range). The line and cross within the boxes show the median and mean respectively. The top and bottom lines extending above and below the box is 1.5 times the inter-quartile range.

Figures 2 and 3 show that Australian DNSPs have a much tighter range than the New Zealand and Canadian datasets. Most Canadian and New Zealand observations are outliers relative to the “whiskers” for the Australian data. This outcome illustrates the significant potential for

distortion of regression parameters by including these capitalisation adjustments within the regression analysis. Therefore, in our view, the AER's current approach to the capitalisation OEF remains fit for purpose, and there are significant challenges with international data on capex and AUC. Please contact [REDACTED] [REDACTED] on [REDACTED] [REDACTED] [REDACTED] or [REDACTED] if you would like to discuss this letter further.

Yours sincerely



Ana Dijanosic
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