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Dear Claire

Thank you for the opportunity to provide comments on the Australian Energy Regulator's (AER) draft 2023 Annual Benchmarking Report (**Draft Report**).

We welcome the AER's collaborative approach to sharing its Draft Report and look forward to ongoing engagement on the AER's benchmarking approach. In providing our feedback we note that the analysis underpinning the Draft Report is unchanged from the preliminary analysis in the Quantonomics report the AER previously shared. Our submission reiterates our concerns on that preliminary analysis and provides additional feedback below on the draft benchmarking report, focusing on:

- Our strong support for the AER's commitment to adjusting for differences in capitalisation approaches when running the multilateral index model (MTFP/MPFP);
- The AER progressing work on how export services should be accounted for in its benchmarking results; and
- Encouraging the AER to continue development work to address potential issues with the Translog econometric models and other improvements.

Multilateral index models and export services

We commend the AER for completing its review of capitalisation differences and their impact on benchmarking, culminating in this year's draft report including the econometric benchmarking results under the AER's preferred method of adjusting opex for capitalisation differences. While the AER has not implemented its preferred approach for the MTFP/MPFP for the Draft Report, it has undertaken preliminary MTFP/MPFP analysis under the preferred approach to addressing capitalisation differences and has shared the results for feedback on its implementation approach. We look forward to providing feedback on this analysis, with a view to having the MTFP/MPFP under the preferred approach also included in the final benchmarking report. This will ensure MTFP/MPFP continues to provide an effective cross-check of the results of the econometric benchmarking models under the preferred approach.

We also note the AER is progressing development work on how export services can be accounted for in its benchmarking and note the AER's timeline for a full review by 2027 when export services data becomes available. We look forward to supporting the AER's further

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consultation and data collection efforts to ensure that appropriate and relevant data is collected to inform this review and the impact on benchmarking.

Development work to improve the performance of the Translog econometric models

We encourage the AER to prioritise development work on improving the performance of the Translog econometric models. This is critical given that the performance of the Translog models has deteriorated as each benchmarking year has rolled forward.

The AER's response to monotonicity violations is to not use the Translog model efficiency score when there are monotonicity violations for a majority of observations for a DNSP or for the majority of Australian DNSPs. This approach does not address the issue of why the Translog models are not meeting the monotonicity requirement. It also creates instability in the regulatory framework by changing the models used to average efficiency scores depending on whether the monotonicity requirement is met from one year to the next.

We remain concerned that the results of the SFA Translog model for Ausgrid seem implausible compared to the increasing efficiency scores indicated by the other three econometric models. We have observed this trend for Ausgrid in both the long and short sample periods, which seems even more implausible given the efficiency improvements we have achieved over the short period.

As raised in our preliminary feedback, our analysis suggested that the estimates for the SFA Translog short-sample period model do not maximise the log-likelihood function. We estimated that if the SFA Translog model were to be estimated correctly for the short-sample period, that is to maximise the log-likelihood function, the resulting efficiency score for Ausgrid would be 3.2%. This score is highly questionable and indicates that this model and the model for the long-sample period may be mis-specified. While the AER has indicated from its initial investigations that it does not agree that the short period model is mis-specified, we also understand that it is continuing to review this issue. We look forward to engaging with the AER during its review, to understand its analysis and reasoning to resolve this issue.

Time trend variable, output weights and other improvements

We support the AER's proposal to examine modifications to the econometric models to include a time trend variable that differs between jurisdictions. As raised in our feedback to Quantonomics' preliminary benchmarking report, there is no variable in the current benchmarking models that captures the improvement in opex efficiency in the Australian DNSPs compared to New Zealand and Ontarian DNSPs, and that this may be impacting the monotonicity results.

The AER has also proposed an independent review of the non-reliability output weights used in the Productivity Index Number benchmarking method as part of its development work. However, no timeframe has been provided for this review. We support an independent review and consider it should be prioritised, given the corrections to some historical benchmarking data since the output weights were last estimated in 2020. Benchmarking data for a few years have also been added since 2020. Our analysis indicates that under the current benchmarking

framework, the historical data corrections and additional years of data have a material impact on the output weights and materially impact MTPF/MPFP comparisons.

As noted in our preliminary feedback, we also consider that the output weights should be updated under the preferred approach to adjusting for capitalisation differences, as this approach materially changes values for the opex inputs.

We support improving quantification of material operating environment factors (**OEFs**) as part of the AER's development work. However, we consider that this should be undertaken within an overall review of OEFs, including the refinement of data and methodology. The AER's current approach appears to be to consider the applicability of new OEFs when these are raised by DNSPs in their regulatory submissions. We note this occurred for the new OEF for workers compensation, which was raised by Evoenergy in its current regulatory reset. We commend the AER's willingness to reconsider OEFs during regulatory determinations, however we think it appropriate to undertake a wider consultation process for OEFs where all DNSPs can contribute to the examination of OEFs including data collection and quantification. It has been more than five years since an independent review of material OEFs and quantification was undertaken by Sapere-Merz, the time may now be appropriate for a major review of OEFs, including considering potentially new OEFs.

Regarding reviewing the benchmarking comparison point from 2025-26, we consider that the timing of this work can only be commenced after the AER has completed its pipeline of development work. All the above development work, particularly improving the performance of the Translog cost function models, are needed to improve the performance of the economic benchmarking models and the reliability of benchmarking. Until these reviews are completed, we consider it more appropriate to continue using a conservative benchmarking comparison point to provide a margin for uncertainties.

We appreciate this opportunity to provide feedback. We look forward to working constructively with the AER as it progresses its economic benchmarking development work and continues to improve the benchmarking methodology.

Regards,

A black rectangular redaction box covering the signature of Fiona McAally.

Fiona McAally
A/Head of Regulation