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To: [REDACTED]
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Subject: RE: AER 2023 Annual Benchmarking Report for distribution - timeframes for consultation [SE=OFFICIAL]
Date: Monday, 4 September 2023 6:41:14 PM

Hi Adam,

Thank you for the opportunity to provide comments on the preliminary 2023 Quantonomics benchmarking report. We would welcome further discussion if some of the points require clarification or if further information would be helpful – let me know if you would like to set something up.

Set out below are issues of material concern for Ausgrid from the benchmarking report. These include:

- not presenting opex MPFP results using Option 5 opex data, which may distort the usefulness of the opex MPFP as a 'cross-check' on the results from the econometric benchmarking models;
- output weights for MTFP/MPFP should be recalculated as they are based on incorrect historical data that has now been corrected;
- monotonicity violations remain a concern, potentially because 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
- the results of the SFATLG model seem implausible compared to the increasing efficiency scores indicated by the other three econometric models.

Opex MPFP modelling

The AER/Quantonomics' preliminary benchmarking report has not undertaken opex MPFP modelling using opex data under its Option 5 approach, which is the AER's preferred option of adjusting for capitalisation differences. We understand the AER is concerned about implementation issues involving the potential double counting of expenditure across MPFP/MTFP when adjusting for capitalised overheads.

Our view is that the AER could include opex MPFP results using Option 5 for the following reasons:

- to ensure consistency of analysis and comparability of results derived using the econometric models and the opex MPFP analysis, the same opex series should be used across all opex benchmarking models. The AER uses the results from the opex MPFP analysis as a cross-check on the results from the econometric models, which is not meaningful if the opex MPFP and econometric models have been implemented using inconsistent data.
- we accept that it may be challenging to implement the capital MPFP and MTFP models using the Option 5 opex data. However, our view is that the AER should present the opex MPFP results using the Option 5 opex data, while recognising in the report that it may not be feasible to do the same with the capital MPFP and MTFP models.
- capitalised corporate overheads in capex only have an indirect impact through the calculations of the capital input weights that are based on the annual user cost of capital (AUC), and are therefore not material.

It is of particular concern that not applying Option 5 will lead to an inconsistent opex measure across the AER's econometric benchmarking and opex MPFP models. While the AER uses only the econometric benchmarking models for the roll forward of efficient base year opex, it has been standard practice is to rely on the opex MPFP analysis to inform and cross check outcomes from the econometric models. It is therefore important that this informed analysis be based on a consistent definition of opex across benchmarking models.

MTFP/MPFP Output weights

Several DNSPs have made revisions to their historical benchmarking data to correct data errors that have been identified recently. This was noted by Quantonomics on page 5 of its report. The revised data has been used to perform the MTFP/MPFP analysis and these revisions have affected the benchmarking results materially in some cases. However, Quantonomics has not updated the output weights. The current output weights were last estimated by Economic Insights in 2020 and as Quantonomics noted, intended to apply for several years. However, these output weights had been estimated using historical data which is now recognised as incorrect.

Whenever the inputs and/or outputs change, the output weights also change. Changes in the output weights can have a major impact on a DNSP's MTFP and MPFP index scores and rankings. Our analysis indicates that under the current benchmarking approach, the historical data revisions and additional years of data have a material impact on the output weights and materially impact MTFP/MPFP comparisons.

For consistency, we also consider that the output weights should be further updated under the preferred approach to opex, as this materially changes values for the opex inputs.

Monotonicity in econometric models

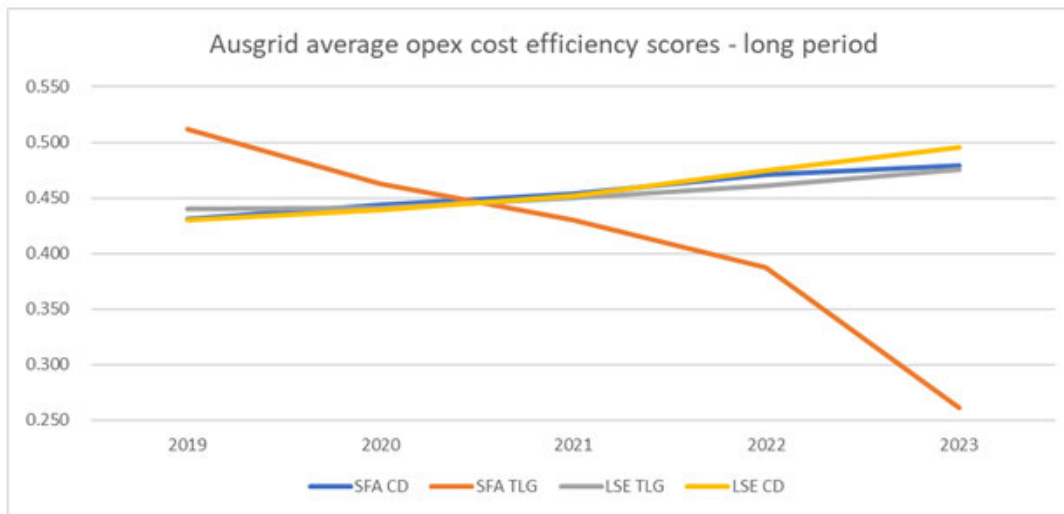
We are concerned with the increasing monotonicity violations for the Translog models over time. We think that the monotonicity violations in the econometric models may be related to the assumption that efficiency remains constant over time. However, as shown in MPFP results many DNSPs have made significant efficiency improvements over time, however there is no variable in the current benchmarking models that captures this improvement in the Australian DNSPs. This may be an area of investigation for Quantonomics to correct the monotonicity violations.

SFA TLG models

While no monotonicity issue has been raised in Ausgrid's results from the SFATLG model for the long period (using the standard approach), we are concerned with the indicated declining efficiency scores compared to the results from the other three economic models and opex MPFP. As summarised in the table and chart below, the results of the SFATLG model seem implausible compared to the increasing efficiency scores indicated by the other three econometric models.

Ausgrid average opex cost efficiency scores, long period

Reference to Annual EI/Quantonomics Benchmarking report	Table 3.3	Table 3.5	Table 3.4	Table 3.4	Table 3.4 (standard opex)
Benchmarking year	2019	2020	2021	2022	2023
SFA CD	0.431	0.444	0.454	0.471	0.479
SFA TLG	0.512	0.463	0.430	0.387	0.261
LSE TLG	0.440	0.441	0.450	0.461	0.476
LSE CD	0.430	0.439	0.452	0.475	0.496



Further, our analysis suggest that the estimates for the SFA Translog short-sample period model do not maximise the log-likelihood function. We estimate that if the SFA Translog model were to be estimated correctly for the short-sample period, the resulting efficiency score for Ausgrid would be 3.2%. This appears to be implausible and indicates that this model (and the model for the long-sample period) may be mis-specified.

We suggest that the AER/Quantonomics should investigate what is driving these results for Ausgrid and whether the same observation is present for other DNSPs.

Thanks again for the opportunity to provide feedback. We look forward to engaging further with you on the above issues and as the 2023 benchmarking report is refined.

Regards,

Fiona