Mr Sebastian Roberts
General Manager Network Expenditure
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

20 October 2016

Dear Mr Roberts

2016 Draft Benchmarking Report

On 23 September 2016, the Australian Energy Regulator (AER) circulated for comment a draft copy of the Annual Benchmarking Report (2016 Draft Benchmarking Report), forward dated to November 2016. This is the third such annual benchmarking report under the new National Electricity Rules. The AER also provided a memorandum from its consultants Economic Insights (EI) dated 15 September 2016 together with the underlying data and models used in the benchmarking analysis.

Since the first benchmarking report was issued by the AER in 2014, there has been considerable debate and disagreement regarding the appropriate model specification, data inputs and adjustments that should applied to the AER's approach. Following lack of resolution on these issues, ActewAGL Distribution (AAD) appealed the AER's approach and use of benchmarking during the 2015-19 distribution determination process. The Australian Competition Tribunal (ACT) considered that the RIN and overseas data used by the AER was not fit for purpose and concluded that there were serious deficiencies in the AER's model. Certain of the ACT's findings, such as those concerning the RIN data, are equally applicable to the other economic benchmarking analysis employed by the AER in the 2016 Draft Benchmarking Report. The AER is currently appealing the ACT's decision on judicial review grounds to the Federal Court.[1]

The 2016 Draft Benchmarking Report is unresponsive to the ACT's findings, relying largely on the same data, economic benchmarking analysis, findings and reasoning as previous benchmarking reports.

[1] Nothing in this response should be taken to prejudice our submissions in these proceedings.

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With respect to the AER's model, there have been minimal changes to the analysis,[2] despite the serious deficiencies that have been identified by the ACT, with the AER claiming:

- the benchmarking models presented are the most robust measures of overall efficiency available to it;
- the benchmarking allows the comparison of DNSP performance and provides incentives for DNSPs to learn from each other and improve their performance; and
- the benchmarking presented in its report will be one of the factors considered in making its revenue determinations.[3]

Accordingly, AAD refers to and repeats its contentions before the AER and subsequently the ACT in respect of the AER's economic benchmarking analysis.[4] AAD does not accept that the AER's benchmarking models can be considered the *most* robust measures of overall efficiency available. From a statistical basis, there are clearly superior models available, some of which were presented to the AER during the last regulatory determination. Further, benchmarking only allows comparisons of DNSP performance if the comparisons are valid. Biases in the AER's model specification mean that the results of its benchmarking analysis cannot be considered a true reflection of the absolute or relative productivity performance of DNSPs. Therefore, AAD disagrees that the benchmarking presented in the 2016 Draft Benchmarking Report can be used to inform revenue determinations.

While AAD appreciates the AER's reasons for maintaining its existing approach to economic benchmarking, pending the outcome of its appeal before the Federal Court, AAD maintains that, in the event that the Court affirms the ACT's decision concerning opex, it will not be open to the AER to apply the analysis and conclusions reached in that Report in making AAD's 2019-24 distribution determination.

Pending the outcome of the AER's Federal Court appeal, AAD makes the following additional comments on the 2016 Draft Benchmarking Report.

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[2] The EI memorandum states that it has been asked to update the results presented in the AER's 2015 Benchmarking Report with the updates involving data for the latest Economic Benchmarking Regulatory Information Notice and a small number of revisions to DNSP data.

[3] AER 2016, Draft Annual Benchmarking Report, Electricity distribution network service providers, November, p.8.

[4] AAD's concerns with the AER's approach to benchmarking are detailed in its submission to the AER's 2014 Draft Benchmarking Report dated 3 September 2014, AAD's Revised Regulatory Proposal of 20 January 2015, and its merits and judicial review applications, primary and reply submissions, and oral submissions. As a result, AAD does not repeat these concerns here.

With respect to the data used by the AER, AAD encourages the AER to work with the industry to investigate how to better normalise the RIN data before conducting the various analyses.

Importantly, AAD is concerned that the AER continues to use expenditure data that has been estimated under the pre-2013 Cost Allocation Methodology (CAM), despite AAD adopting a new CAM from June 2013. It is to be noted that AAD provided to the AER, in March 2016, estimated back cast expenditure data for 2006-13 as if the new CAM had always been in place. It is important that the AER assesses AAD's relative performance consistently with the latest RIN information by utilising the revised back cast information based on the current CAM.

If the AER is committed to improving its benchmarking technique in the future then it needs to go beyond simply refining its benchmarking tools.[5] It must be open to considering alternative approaches, engage genuinely with industry and experts on the concerns that have been raised and, in particular, investigate the reasons why:

- the multilateral total factor productivity (MTFP) model results in the same set of firms performing as "most" or "least" productive over time, in particular, to what extent do model specification issues bias the results because the MTFP does not account for differences in network design or operating differences;
- it would require completely unrealistic expectations of opex to move one of the "least" productive DNSPs to the position of one of the "most" productive under the AER's MTFP model. For example, to be in the top 4 performers in terms of opex, AAD estimates that its annual opex would need to be reduced by a further 50 per cent over and above the 36 per cent decrease already generated from the 2015-19 distribution determination;
- the AER recognises the need to adjust the stochastic frontier analysis for operating and environmental factors but makes no such adjustments to the MTFP analysis[6]; and
- the MTFP results are so sensitive to changes in the specification and to what extent this limits the usefulness of the results for informing revenue determinations. For example, as AAD has previously demonstrated, changes to the way in which cable lengths are measured and how high voltage assets are treated in the model have

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[5] The improvements required to the AER's benchmarking approach go well beyond an improvement to data systems as foreshadowed in the AER's Statement of Intent 2016-17, p.16.

[6] AAAD maintains that the RIN data should be normalised as much as possible to account for differences between DNSPs, and ideally carried out before conducting the econometric analysis, thereby reducing the need for ad-hoc post-modelling adjustments.

significant impacts on the relative productivity results.[7]

If you wish to discuss any aspect of our response, please do not hesitate to contact Alexis Hardin, Manager Regulatory Finance and Strategy on 02 6248 3033 or alexis.hardin@actewagl.com.au.

Yours sincerely,

David Graham

Director Regulatory Affairs and Pricing

[7] AAD 2014, Response to the AER's Draft Annual Benchmarking Report, p.9-10, September.