Mr Tony Weir
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Australian Energy Regulator
GPO Box 520
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11 October 2017

Dear Mr Weir

2017 Draft Benchmarking Report

On 22 September 2017, the Australian Energy Regulator (AER) circulated for comment a draft copy of the two 'results' chapters of the Annual Benchmarking Report to be released in November 2017 (2017 Draft Benchmarking Report). In addition, the AER provided a memorandum from its consultants, Economic Insights (EI), dated 6 September 2017, together with the underlying data and models used in the benchmarking analysis relied on in the Report.

ActewAGL Distribution (AAD) notes that the 2017 benchmarking analysis replicates the methodology used in previous reports, updating the RIN data used in the analysis to include RIN data for 2015/16 and providing a decomposition of the multilateral total factor productivity (MTFP) results.

AAD's key concern is that the AER has provided limited guidance to date on how the AER intends to use the 2017 Draft Benchmarking Report, the underlying benchmarking analysis or benchmarking more generally in assessing AAD's operating expenditure forecasts for 2019-24 in accordance with its obligations under the National Electricity Rules (NER) and administrative law. In AAD's view, the weight that could be given to the 2017 Draft Benchmarking Report and the 2017 benchmarking analysis for this purpose is limited.

The NER require the AER to prepare and publish the benchmarking report on an annual basis with the purpose of describing the relative efficiency of each Distribution Network Service Provider (DNSP) in providing direct control services over a 12 month period (clause 6.27). Further, in the context of making a distribution determination, the AER must have regard to the most recent annual benchmarking report that has been published under rule 6.27 in assessing the reasonableness of AAD's operating expenditure forecast (NER clause 6.5.6(e)(4)). The AER has also stated in its 2017 framework and approach for AAD that it intends to have regard to the assessment tools set out in the current expenditure forecast assessment guideline which includes benchmarking (including broad economic techniques and more specific analysis of expenditure categories)[1].

While the AER has foreshadowed in its framework and approach for AAD that it intends to use benchmarking in assessing AAD's operating expenditure forecasts, it does not provide any guidance as to the benchmarking analysis it will consider and how that analysis will be considered.[2] This is notwithstanding that the AER's NER obligations, first to publish expenditure forecast assessment guidelines that *specify* the approach the AER proposes to use to assess forecast operating expenditure and secondly to set out in its framework and approach paper how it proposes to apply these guidelines to AAD, are intended to ensure the AER provides this guidance.

In AAD's view, the 2017 Draft Benchmarking Report and the benchmarking analysis relied on in that Report could only be afforded limited weight in assessing AAD's operating expenditure forecasts in the upcoming determination process for 2019-24 for the following reasons.

First, the AER uses MTFP as the primary technique to compare DNSP efficiency across the sector and presents MTFP results as the basis for compliance with its reporting requirement under clause 6.27 of the NER[3]. The key difficulty with this approach is that MTFP measures the relationship between total output and total input (both capex and opex) and hence cannot be used to draw conclusions about opex performance alone.

Second, as recognised by the AER, the MTFP results presented may not capture operating environment factors (OEFs) which can affect a DNSPs costs and benchmarking performance and hence the MTFP results presented by the AER can only be interpreted as indicative of DNSP relative performance[4]. It would be inappropriate to rely on such indicative measures as the basis for assessing AAD's opex proposal.

Third, the 2017 benchmarking analysis is produced using the same data sources, model specification and methodology as the benchmarking analysis relied on by the AER in making its 2015 distribution determinations for AAD and the NSW DNSPs for the 2015-19 regulatory control period, and fails to address the deficiencies with this analysis identified by the Australian Competition Tribunal[5] (Tribunal) which were upheld by the Full Federal Court.

In its decisions in February 2016, the Tribunal identified inadequacies in the data set used for the AER's benchmarking analysis (including in particular in the RIN data) and deficiencies in the underlying modelling assumptions and the way the analysis provides for comparability issues, and found error in the AER's reliance on the output of this analysis in making its 2015 determinations. It is true that the AER placed primary reliance on the output of EI's Cobb-Douglas Stochastic Frontier Analysis model in making its 2015

[1] AER 2017, Framework and Approach ActewAGL: 67.
[2] AER 2017, Framework and Approach ActewAGL: 67.
[3] AER 2017, Draft Benchmarking Report: 8 and 13
[4] AER 2017, Draft Benchmarking Report: 13
[5] Australian Competition Tribunal 2016. Application by ActewAGL Distribution [2016] ACompT 4,

distribution determinations, while the 2017 Draft Benchmarking Report places primary reliance on EI's MTFP results. However, the Tribunal concluded that these models (together with the other models relied on by the AER in making its 2015 distribution determinations and again in the AER's 2017 Draft Benchmarking Report) were closely related, all derived from the same data and missing the same wider review of factors and sense checks. The Full Court affirmed these Tribunal conclusions and findings in its May 2017 decision on the AER's appeal of the Tribunal's decision.

The AER has made no attempt to address the deficiencies identified by the Tribunal or the Tribunal's order concerning operating expenditure (which provides for the AER to use a broader range of modelling and benchmarking against Australian businesses) in its 2017 Draft Benchmarking Report.

AAD also has the following specific comments on the 2017 Draft Benchmarking Report:

- In presenting the results of econometric modelling and opex multilateral partial factor productivity (MPFP), the AER states that:

  Despite the differences in the model features, the opex efficiency scores produced by the four models are broadly consistent with each other.[6]

  Based on the results presented in Figure 13 of the report, AAD finds it difficult to understand how the AER reaches this conclusion. The indices appear to vary significantly, result in different rankings and move in different directions across DNSPs. For example, some DNSPs have a higher index under the opex MPFP approach compared with the econometric modelling approaches. For other DNSPs, the opex MPFP approach results in lower indices than the econometric modelling approaches. In any event, as the Tribunal concluded (which conclusion was affirmed by the Full Court), the models are closely related, all derived from the same data and missing the same wider review of factors and sense checks, such that consistency in the results produced by the models would be unsurprising and does not provide any evidentiary basis for a conclusion that those results are reliable or probative.

- Given the AER's heavy reliance on the MTFP approach in the 2017 Draft Benchmarking Report, it would seem appropriate that the AER explains its choice of output weights, the sensitivity of the MTFP and MPFP results to those weights and whether it intends to review the weights given the review it recently initiated in the context of transmission benchmarking.

- Given that the purpose of the annual benchmarking report is to describe the relative efficiency of each DNSP in providing direct control services over a 12 month period (NER clause 6.27), it is unclear what purpose is served by presenting productivity results over an average 10 year period (for example, Figure 13) and at the state/territory level. These results provide no insight into the

[6] AER 2017, Draft Benchmarking Report: 19.

relative current performance of DNSPs and in the case of state-based results mask the differing performance and characteristics of individual DNSPs (including customer density). For the same reason, it is unclear why the AER presents partial performance indicators for an average 5 year period rather than the most recent 12 month period for which data is available.

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

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