From: [redacted]
Sent: Friday, 8 April 2022 8:38 AM
To: Rapoport, Adam; Preston, Claire
Cc: [redacted]
Subject: CP/PC/UE views on adjusting for capitalisation policies in benchmarking

Hi Adam and Claire

Thanks for meeting with [redacted] and I a couple of weeks ago to discuss our views on options for adjusting for capitalisation policy in benchmarking. At the time, you asked for our view on the merit of the econometric approach.

We have since discussed the robustness and assumptions of the approach with Essential and their consultants Frontier Economics. Following the discussion, we believe that the economic approach, based on including opex/capital ratios as explanatory variables in the econometric model, is a more preferable option to adjust for capitalisation policy differences than applying these ratios as an ex-post OEF adjustment. The econometric approach has several advantages:

- The key advantage is that it reduces the risk of the adjustments conflating inefficiency and capitalisation practices, improving the logic and robustness of benchmarking outcome.
- It better accounts for the correlation between drivers of different opex/capital ratios, such as line length and customer numbers as these are also directly included in the model, i.e. it better accounts for the genuine reasons why opex/capital ratios would be expected to be higher or lower for different types of networks.
- It allows each DNSP's efficiency to be assessed relative to other networks with similar opex/capital ratios, as noted by Frontier in Essential's submission.
- It avoids relying on an industry benchmark opex/capital ratio which is derived based on analysis that doesn't factor in capitalisation differences.
- The efficiency scores produced from econometric models under different inputs (short/long period and inclusion of the opex/totex and opex/total cost ratios) have lower variance between themselves when compared to the variance of the efficiency scores produced by ex-post OEF adjustments with similar periods and ratios.

We would suggest taking an average of the outcomes under the two ratios, opex/totex and opex/total cost, as a pragmatic approach.

We'd be happy to follow up with a short discussion if you think that would be valuable.

Thanks again,
[redacted]

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