AEMC
Review into the use of Total Factor Productivity for the determination of prices and revenues

Australian Pipeline Industry Association

1 February 2010

Key messages

- Commission can exclude gas transmission now
- Some questions:
  - Is forecasting by extrapolation consistent with NGL objectives and pricing principles?
  - Has the Commission looked sufficiently broadly and deeply at the incentive question and efficiency?
  - Is the information asymmetry issue overstated?
  - What is appropriate timing for Phase 2?
  - Is reporting by all scheme pipelines justified?

Gas transmission can be excluded now

- Pipelines are not comparable
  - Different histories
  - Different ages and technologies – eg pipeline coating, steel
  - Different market/load characteristics and maturity
  - Scale effects – pressure and diameter
  - Different configurations
    - Looping/compression
    - Point to point vs dendritic
    - Number of delivery and receipt points
    - Pressure control vs flow control
    - Storage capacity– volume/compression/load
  - Different geographies/topographies
    - Outback/desert vs developed/urban

the australian PIPELINE industry association Ltd

Differences in Australian pipelines

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Gas transmission can be excluded now

- Productivity in one pipeline is different to another
- Measurement of productivity and extent to which productivity can be improved is pipeline-specific
  - Pipelines are capital intensive – opex 25% of revenue
  - Options for reducing opex are limited and pipeline-specific
  - Expansion options are lumpy and pipeline-specific
- Small data set even if all scheme pipelines included
- Small number of regulated pipelines: no appetite among them for TFP
- Summary –TFP unlikely to be workable or useful for pipelines

Gas transmission can be excluded now

- Summary –
  - Analysis to determine if TFP is appropriate to pipelines can be done relatively easily now
    - No time series analysis required
    - Would be wasteful to continue gathering data
  - In APIA's view no net benefit from using TFP for gas transmission

Some Questions

- Is the use of TFP compatible with the NGL and NGR?
- Has the Commission considered the incentive question and efficiency in sufficient depth?
- Is the information asymmetry issue overstated?
- What is appropriate timing for Phase 2?
- Is reporting by all scheme pipelines justified?

Is the use of TFP compatible with the NGL and NGR?

- Is forecasting by extrapolation consistent with NGL objectives and pricing principles?
- NGO – efficient investment, operation and utilisation
- RPPs – “a reasonable opportunity to recover **at least** the efficient costs”
- NGR - requires forecasts to be “reasonable” and “best possible in the circumstances” (NGR s74)
- a past “inefficient” average to forecast a specific “efficient” future
- Impact of the convergence effect?
- Extrapolation may be sometimes be acceptable BUT TFP contemplates extrapolation to all price/revenue

Is the use of TFP compatible with the NGL and NGR?

- Significant pre-conditions for TFP:
  - "**if the initial cap is set to recover the efficient level of costs** (including capital funding costs), and **[if] the historical TFP growth rate reflects productivity growth that can be expected going forward**, then the service provider **should be able to earn** a reasonable rate of return and recover efficient costs" (AEMC p 3 and similar at p 40)
- Not clear that the scheme proposed can satisfy these pre-conditions
- Is TFP compatible with NGR s74 and with Revenue and Pricing Principles (NGL s24)?
- Would it be acceptable or well founded to amend NGR s74 and/or NGL s24 to accommodate TFP?

Incentives and efficiency – has the ground been covered?

- Will service providers respond to TFP measures as predicted?
  - Assumptions – TFP will be higher? 2nd order response? – new and untested
  - One angle, other angles?
  - One example, counter examples?
- Does cost reduction equal efficiency improvement?
- Is there an overshoot problem? How do we know?

Is the information asymmetry issue overstated?

- Little asymmetry in respect of historic information
- Forecasting information require for P0 in any event – using “efficient” building blocks
- Businesses have difficulty forecasting 5 years and whether costs are “efficient” – 1 - 2 years maybe
- “A voyage of discovery” for business
- Current requirements of the NGR and AER guidelines (and NER) very comprehensive

Timing of Phase 2

- Commission position on Phase 2 timing unclear
- Strong case for deferring Phase 2
  - Data requirement means implementation at least 8 years away (assuming 8 years accepted)
  - Defer Phase 2 for at least 5 years
    - Relatively new gas (and electricity) regimes bedded down under AER
    - Smart networks and advanced metering further advanced
    - Carbon reduction response understood
    - Ofgem RPI-X@20 review completed
    - Theory and practice of TFP regulation further developed
    - AEMC & industry may change views over 5 – 8 years

Is reporting for pipelines justified?

- Proposal is that all scheme pipelines should report
- Even assuming a low likelihood that TFP will be extended to transmission or, if it was, that any covered pipeline would opt for TFP
  - Reporting cannot be justified by TFP
  - TFP reporting should place no additional burden on pipelines