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Dr John Tamblyn
Chairman
Australian Energy Market Commission
Level 5, 201 Elizabeth Street
Sydney NSW 2000

By email to: submissions@aemc.gov.au

Dear Dr Tamblyn

**Submission to first round consultation: National Electricity Amendment
(Total Factor Productivity for Distribution Network Regulation) Rule 2008**

EnergyAustralia welcomes the opportunity to provide comments on the above captioned Rule change proposal. EnergyAustralia has been a keen observer of this issue through its development, and has participated in forums and discussions undertaken by the Victorian Department of Primary Industries.

Through its research, observation, and participation in these forums, EnergyAustralia remains unconvinced that TFP will ever be a viable substitute for the current building block approach for distribution networks. It is not clear that TFP will support at least the efficient costs of providing network services, or that it will address the regulator's concerns regarding information asymmetry.

In the context of the Rule change application, EnergyAustralia's comments fit into two major categories:

- EnergyAustralia considers it inappropriate to propose a Rule change to allow TFP in the absence of a study on the applicability and suitability of a TFP framework to the Australian regulatory arena; and
- There are significant practical procedural issues raised by the Victoria DPI TFP approach.

Appropriateness of proposing a Rule change in the absence of a study on the applicability of a TFP framework to the Australian regulatory arena

It is clear to EnergyAustralia that, with the exception of a few devotees, there is little consensus on whether TFP is a useful tool in the Australian regulatory context. This message comes through clearly in the Expert Panel report of April 2006 (page 96):

Generally, the emphasis in submissions addressing the development of TFP-based price control methods was towards ongoing examination of TFP as an approach rather than for a detailed specification by the Panel of how the approach would work.

Submissions to the Panel's draft report developed these same themes, but with more clearly expressed reservations among service providers at the possibility that the AEMC may mandate the adoption of TFP-based control setting methods, particularly when this approach remains untested in Australia.

The Expert Panel also concluded that (page 103):

There is no basis for concluding that one approach has intrinsically stronger or weaker efficiency incentives than the other – this depends on the detailed parameters adopted under any particular application of either model.

While EnergyAustralia agrees in principle that there is benefit in the Australian regulatory regime being able to evolve to allow for flexibility of approaches (including TFP), it is clear that the model needs to be defined and articulated before it is encapsulated into the Rules. The Victoria DPI proposed Rule change delegates responsibility for developing the details of the model to the AER. It is not reasonable to expect NEM participants to endorse a Rule change when the fundamental underpinning definitions, parameters and other key features of the model remain unspecified. Further, it is difficult to see how the AEMC could be satisfied that such a rule will or is likely to contribute to the achievement of the national electricity objective without a detailed knowledge of TFP's history of success, suitability within the Australian context, and detailed understanding of how such a scheme might operate.

EnergyAustralia is concerned with the vision that the proposed Rule will require the AER to develop a "quasi-binding" guideline on the definition, measurement and mechanics of the TFP model. EnergyAustralia considers that this is a major retrograde step, which returns the Australian regulatory framework to the non-binding "Statement of Regulatory Principles" era. Policy makers and legislators have invested almost five years in developing a new set of Rules to provide greater certainty, and this proposal flies directly in the face of those initiatives.

EnergyAustralia continues to support the Expert Panel's clear recommendations on the subject (page 106):

The Panel recommends that the NEL and NGL include provisions that enable the AEMC to make Rules in relation to TFP and that the MCE direct the AEMC to undertake a review, by 31 December 2008, that addresses:

- the circumstances in which the application of a TFP-based price setting methodology would contribute to the NEL and NGL objectives;
- the data collection arrangements that need to be put in place to facilitate its application; and
- as appropriate, the development of draft Rules to support the application of a TFP-based form of control for any individual or group of electricity or gas distribution or transmission service providers.

In summary, EnergyAustralia finds it impossible to support a Rule change to allow TFP as a regulatory revenue determination mechanism without a clear specification of the model and measures that are fundamental to the TFP approach.

Practical procedural issues in the Victoria DPI TFP approach

EnergyAustralia has identified a number of issues relating to the practical implementation of the Victoria DPI TFP Rule proposal, notwithstanding the issues surrounding the definition of the model and the measurement of inputs and outputs.

One of the key matters raised by the businesses consulted in the DPI presentations was a requirement for certainty that the TFP-based approach could not be imposed by the regulator upon a network business. While this is the clear intention of the proposal, it is not certain that this would be achieved through the drafting for the proposed Rule. EnergyAustralia would prefer an explicit statement to the effect that the AER is not empowered to impose a TFP approach without the consent of the network business. This could be achieved by the Rules clearly stating that the decision to lodge a building block proposal or a total factor productivity proposal (TFP proposal) is a matter for the DNSP to decide, and the AER may only make a total factor productivity determination (TFP determination) where a DNSP has lodged a TFP proposal.

EnergyAustralia is concerned that the Victoria DPI TFP Rule proposal does not provide sufficient certainty on the acceptance of a TFP-based proposal to allow a DNSP to confidently prepare a TFP-based regulatory proposal. In

particular, it does not provide certainty as to when the TFP approach could be considered “locked in” during a DNSP’s regulatory determination process.

Under the Victorian proposal, a DNSP wishing to use the TFP approach must advise the AER in writing that it is considering applying the TFP methodology instead of the building blocks approach as soon as practicable after commencement of consultation on the framework and approach paper. This places obligations on the AER in preparing the framework and approach paper. It should be noted that the most comfort that can be gained by the DNSP at this point in the process is the AER’s likely approach to the application of the methodology and its reasons. The DNSP would then need to decide whether to submit a regulatory proposal using a TFP framework.

If a DNSP submits a TFP proposal, the next steps are unclear. The DPI proposal, at p36, appears to indicate that a decision would be made on whether the AER accepted the application of TFP methodology to the DNSP at the preliminary examination stage, which would be as soon as practicable after submission. However, the table on page 37 of the proposal indicates that “(a)approval for application of the TFP approach” occurs 9 months prior to the end of the currently regulatory control period, i.e. four months after submission. The information provided in this diagram, and the proposed draft Rule appears to be inconsistent.¹

The proposed drafting further adds to the confusion. For example, proposed clause 6.2.4A (a) refers to the DNSP making “application” to have the TFP method apply and requires the AER to decide “at the determination stage” whether TFP or a building block methodology applies. This indicates that a final decision on acceptance of the TFP approach is not made until final determination stage.

Proposed new clause 6.9.1 provides for the AER to make an assessment at the preliminary examination stage “whether any of the matters set out in the new clause 6.2.4A(b) do or are likely to apply” and to provide a notice to the DNSP if it does form such a view. Precisely what is assessed, decided and notified at this stage is unclear. The proposal seems to indicate that at this stage, after the regulatory proposal has been fully prepared, the AER assesses whether the criteria for application of TFP have been met and contemplates that a notice can be given effectively requiring the proposal to be resubmitted as a building block proposal² within 30 business days. EnergyAustralia’s recent experience indicates that it is not possible to produce a building block proposal from the ground up in such a short period. The regulatory proposal EnergyAustralia filed with the AER in June for the 2009-14 regulatory period, incorporated two years of detailed analysis and planning. EnergyAustralia considers that a regulatory proposal developed under a building block model is likely to be profoundly different to one prepared under a TFP framework.

The DNSP needs certainty on the framework under which its Regulatory Proposal will be filed well in advance of the submission date. A lack of certainty would force the DNSP to prepare two regulatory proposals in parallel – one on the TFP approach, and another on the building block approach, to be filed in the event the AER rejected its application to adopt the TFP approach. This is clearly a costly impost and a waste of scarce resources.

This “parallel proposal preparation” would be required, as the framework for the AER’s acceptance of the TFP approach is not sufficiently rigorous. The Rule proposal seems to indicate that the AER assesses whether the criteria for application of TFP have been met. However, the preliminary assessment appears to be an enhanced compliance check but not an assessment of whether TFP is appropriate. It is not clear whether the matters in the new clause 6.2.4A will apply or are criteria to be met. For example, (b)(1) refers to “the adequacy, quality and period of the data available for and relevant to the total factor productivity methodology”. It does not require a specific assessment that the data is a) inadequate such as to justify a notice; or b) that it is adequate and therefore does not warrant a notice. EnergyAustralia notes that the absence of explicit assessment makes it unclear how (or if) the AER’s decision not to accept a TFP-based regulatory proposal could be subject to review.

EnergyAustralia is concerned about the apparent inconsistency regarding the use of pass-through provisions and the use of global (US) TFP data. On one hand the discussion paper notes that the US model uses “off-ramps” when rates of return fall outside acceptable bounds. It is not proposed that this approach be adopted in Australia and consequently, the

¹ There may be an error in the diagram in that it would be reasonable for it to read “nine months prior to filing” i.e. 22 months before the end of the regulatory period. This would be consistent with the timing of the Framework and Approach paper, but still does not provide certainty to the DNSP that the proposed TFP approach would be accepted by the AER when the Regulatory Proposal was filed.

² The discussion paper accompanying the Rule change proposal envisions that this replacement Regulatory Proposal would be a building block proposal. However, this is not clearly articulated in the drafting. Proposed 6.9.2(a) states that a DNSP must resubmit its regulatory proposal in an amended form if it receives a notice, but importantly new 6.9.2(aa) states that this does not require the DNSP to amend its regulatory proposal by replacing its total factor productivity proposal with a building blocks proposal, but it may do so.

US data would not be comparable (Rule proposal report p25). However, the discussion paper proposes to supplement the limited Australian data with US data, on the grounds that there is a wealth of US data available (Rule proposal report pp19, 29 and 31).

EnergyAustralia considers it important that this inconsistency is addressed, as it goes to the nature of the model comparators. Of note, EnergyAustralia is concerned that there will be too few Australian comparators whose networks are in a “steady state” and whose future “capital expenditure has a relatively smooth profile” (Expert Panel p104). As discussed in its regulatory proposal, EnergyAustralia is entering a period of significant capital replacement, and as a result would not meet the “steady state” and “smooth capex profile” criteria. Indications are that other Australian businesses will be in a similar investment phase over the next few regulatory periods. This suggests that there will be too few Australian comparators available to measure industry productivity.

EnergyAustralia is also alarmed at the reference to using US data. While the DPI discussion paper notes the long history of US data, it does not acknowledge that this data is prepared under the rigorous FERC reporting requirements, as mentioned in the Expert Panel report (p103). More importantly, the DPI proposal appears to neglect the fact that no Australian business reports its data under the same framework. In EnergyAustralia’s experience, matters as simple as different capitalisation policies can render input data incomparable for benchmarking purposes.

In the context of a preliminary consultation paper, EnergyAustralia has focused on the foundation issues identified:

- that a Rule change is premature in the absence of research on the appropriateness of the TFP approach in the Australian context and clear specification of the model; and
- the procedural framework must be specified in order to give the DNSP certainty to file a TFP-based regulatory proposal with confidence that its use of the TFP approach will be accepted by the AER.

EnergyAustralia would be pleased to answer any further questions you may have, and looks forward to ongoing participation in this Rule change consultation process.

Yours sincerely



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EnergyAustralia