

22 August 2008

Dr John Tamblyn
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ENA Submission - Total Factor Productivity for Distribution Network Regulation

Dear Dr John Tamblyn

The Energy Networks Association (ENA) is pleased to respond to the invitation for comment, by the Australian Energy Market Commission (AEMC), on the proposed *National Electricity Amendment (Total Factor Productivity for Distribution Network Regulation) Rule* lodged by the Victorian Minister for Energy and Resources.

ENA is the peak national body for Australia's energy networks which provide the vital link between gas and electricity producers and consumers. ENA represents gas distribution and electricity network businesses on economic, technical and safety regulation and national energy policy issues.

The Victorian Total Factor Productivity (TFP) Rule proposal, if accepted, could result in a major change to the model of third party access pricing regulation applying to Australian electricity distributors.

ENA Members have reviewed the proposal submitted to AEMC and are concerned that the Rule Change mechanism and its legislatively prescribed timetables may not have the flexibility and scope to comprehensively examine all of the issues raised by this very significant proposed Rule change.

ENA recommends that further AEMC consideration of the Rule change proposal should include the issues raised in the ENA submission; that AEMC undertake a full and comprehensive review of how TFP would be administered before the detailed wording of the proposed Rule change can be considered; and that the AEMC Issues Paper should set out its intended investigative and analytical approach to provide the information necessary to evaluate the draft Rule determination.

Should you seek further information on the ENA submission please do not hesitate to contact me.

Yours sincerely



Vicki Brown
Director Energy Networks Policy



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Energy network sector response

22 August 2008

1. Summary

The Energy Networks Association (ENA) is pleased to respond to the invitation for comment, by the Australian Energy Market Commission (AEMC), on the proposed *National Electricity Amendment (Total Factor Productivity for Distribution Network Regulation) Rule* lodged by the Victorian Minister for Energy and Resources.

The Victorian Total Factor Productivity (TFP) Rule proposal, if accepted, could result in a major change to the model of third party access pricing regulation applying to Australian electricity distributors.

ENA Members have reviewed the proposal submitted to AEMC and are concerned that the Rule Change mechanism and its legislatively prescribed timetables may not have the flexibility and scope to comprehensively examine all of the issues raised by this very significant proposed Rule change. It is noted that similar considerations led the MCE Expert Panel on Energy Access Pricing to recommend that the MCE direct the AEMC to undertake a full review of the TFP approach as an initial step before any Rule change was developed.¹ As the Rule change proposal differs in material respects from that discussed in detail by the Expert Panel, this need is reinforced.² A feature of the proposed Rule change that is strongly supported by ENA is that the application of the TFP approach can only occur at the election of the distributor.

¹ MCE Expert Panel on Energy Access Pricing, April 2006, p.117.

² For example, trigger arrangements and off ramps do not form part of the Victorian rule change proposal, cf. MCE Expert Panel on Energy Access Pricing, April 2006, p.109.

Many of the energy network businesses do not consider that there is sufficient certainty at this time around some of its key operational features to make a judgement on whether the proposed Rule change is likely to contribute to the national electricity objective. Without further detailed examination of this issue, energy network businesses cannot be assured that this proposed change would not substantively increase regulatory uncertainty, or that the implementation and operational risks of the approach will be outweighed by the benefits. This highlights the need for a careful and comprehensive review of the TFP approach.

2. Background

The Energy Networks Association (ENA) is the peak national body for Australia's energy networks which provide the vital link between gas and electricity producers and consumers. ENA represents gas distribution and electricity network businesses on economic, technical and safety regulation and national energy policy issues.

Energy network businesses deliver electricity and gas to over 13 million customer connections across Australia through approximately 800,000 kilometres of electricity distribution lines. There are also 76,000 kilometres of gas distribution pipelines. These distribution networks are valued at more than \$40 billion and each year energy network businesses undertake investment of more than \$5 billion in distribution network operation, reinforcement, expansions and greenfields extensions. Electricity transmission network owners operate over 42,000 km of high voltage transmission lines, with a value of \$10 billion and undertake \$1.2 billion in investment each year.

3. Issues for consideration

ENA Members consider that the proposed Rule change raises issues of fundamental significance for the industry.

The application of a TFP-based pricing approach will affect the ongoing operations of electricity distribution businesses in a direct way by determining the level of prices and regulated revenues and driving network investment incentives. ENA Members are concerned that an inappropriately designed TFP-based pricing regime will have implications for the medium-term financial sustainability and viability of electricity distribution businesses.

ENA members consider that before the proposed Rule change can be assessed, there is a need for greater detail on how TFP will be implemented. The proposed Rule change envisages that much of this detail will be addressed in a guideline to be issued by the AER. However, ENA believes that before considering the proposed Rule change more clarity needs to be provided on the mechanics of a TFP scheme. This will require a full and comprehensive assessment of the application of TFP to be undertaken.

ENA considers that there are a number of critical issues which should form part of a comprehensive assessment by the AEMC. These include:

Relationship to the energy law framework

- What is the capacity of the TFP approach to meet the access revenue and pricing principles in the *National Electricity Law*, in particular a requirement that a distributor should have a 'reasonable opportunity to recover at least the efficient costs' of providing services?
- Would this principle still be satisfied in the full range of circumstances that might arise under the proposed Rule?
- For example, would it be satisfied where a distributor was refused the ability to revert to a cost-based pricing approach in circumstances in which it considered its productivity trend performance was likely to depart significantly from estimated industry averages.
- What accountabilities, including review mechanisms, would be present for key AER discretionary decisions (such as the decision to decline the application of the TFP approach, or continue it in circumstances which the distributor considers inappropriate)?

Potential risks, costs and benefits

- On balance, will the TFP approach increase the risk to electricity distributors through estimation errors contained in regulatory decisions or lower these risks?
- Will the benefits of the TFP approach outweigh the possible additional regulatory uncertainty caused by the high number of subjective design choices underpinning any application of a TFP approach?
- Will the requirement to still undertake regular cost-based building reviews mean that in practice a TFP approach would involve only small savings in regulatory reset costs, and constrain the incentive characteristics that might otherwise be inherent in a TFP regime?
- What will be the level of data collection costs imposed on individual businesses and their customers where a TFP approach is not being applied, in order to support its application (and potential benefits) elsewhere?

Technical feasibility

- How will a robust measure of inputs and outputs required for the TFP approach to be implemented be reached where the set of standard control services between individual businesses differs?
- What risks would a TFP approach applied to an electricity distributor undergoing a significant process of asset renewal or upgrading present?
- Does sufficient robust data exist to determine either a rolling or long term average industry-wide TFP trend?

- Is there a transparent and widely accepted methodology for removal of the impacts of any cost pass through measures from TFP measures?³

Transparency of regulated charges

- What implications does the highly technical nature of the application of the TFP approach have for the overall transparency of regulated charges and the capacity of stakeholders to understand, effectively participate in, and have confidence in the outcomes of the regulatory reset process?

4. Recommendation

ENA recommends:

1. Further AEMC consideration of the Rule change proposal should include the issues raised above. More specifically, the AEMC needs to undertake a full and comprehensive review of how TFP would be administered before the detailed wording of the proposed Rule change can be considered.
2. The AEMC Issues Paper should set out its intended investigative and analytical approach to provide the information necessary to evaluate the draft Rule determination.

³ See Proposed Rule Change to the Australian Energy Market Commission to Permit the Use of the 'TFP Approach', Victorian Department of Primary Industries, May 2008, Attachment A, Clause 6.6A.6 (f) (3), p.13.