

22 August 2008

Dr John Tamblyn  
Chairman  
Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

Dear John,

Re: Total Factor Productivity for Distribution Network Regulation –  
Proposed Rule Change

## 1 Introduction

SP AusNet welcomes the opportunity to make this submission in response to the Rule change proposal submitted by the Victorian Department of Primary Industries (DPI) to allow the Australian Energy Regulator (AER) to apply Total Factor Productivity regulation to Distribution Network Service Providers (DNSPs). In addition to submitting draft provisions, the DPI has also provided a supporting paper which seeks to explain the rationale for the Rule change proposal and its compliance with the National Electricity Law.

SP AusNet notes and supports the Commission's decision to publish an Issues Paper before making a draft rule determination. In particular, SP AusNet concurs with the Commission that this additional consultation stage will give stakeholders a further opportunity to comment on the proposal and inform the Commission's assessment of the issues raised. In this regard, and as a member of ENA, SP AusNet notes the issues raised by the ENA in its submission and supports the need for an improved understanding of the TFP regulatory regime to be implemented, as could be provided through addressing those issues.

The remainder of this submission is structured as follows:

- Section 2 provides high-level comments on the Rule change proposal;
- Section 3 discusses specific issues of concern to SP AusNet and, where appropriate, responds to arguments presented by the DPI in its supporting paper;
- Section 4 focuses on the draft provisions, noting in particular those clauses that raise issues of concern for SP AusNet; and
- Section 5 sets out SP AusNet's concluding comments.

## 2. High level comments

The proposed Rule would provide DNSPs with the option to request the AER to change the determination methodology from the existing building blocks approach to a Total Factor Productivity (TFP) approach. The TFP approach sets the trajectory of allowed prices (i.e. it sets an X factor) with reference to the estimated growth in total factor productivity of the industry and the industry's input prices. From SP AusNet's perspective, the TFP approach has a number of attractive features compared to the building block approach, which are noted in the following three quotations from the DPI's supporting paper:

"The X factor under the TFP approach will be set with reference to measured TFP, rather than forecasts of firm-specific expenditure and demand, and hence be less affected by problems of the asymmetry of information between the AER and distributor<sup>1</sup>."

"The TFP approach is compatible with providing incentives for distributors to set efficient prices and to reward distributors for their level of service performance, and these incentives may be expected to be stronger than under the building block approach<sup>2</sup>."

"One of the key benefits expected from the TFP approach is to reduce the administrative cost of regulation by setting the trajectory of prices to the extent possible with reference to 'known and measurable' information, and hence relying much less on forecasts<sup>3</sup>."

In light of these statements, SP AusNet considers that a Rule change proposal enabling TFP to apply to DNSPs would provide an important and welcome improvement to the existing Rules. In broad terms, it would provide an opportunity to advance to a *better* form of regulation that has the potential to provide better outcomes to customers and regulated companies. Importantly, SP AusNet sees the benefits of the TFP approach in terms of "growing the pie" rather than re-cutting the shares between customers and industry.

Whilst TFP has the potential to provide a *better* outcome, there are no guarantees. In fact, the methodology and its application raise a number of important challenges, which are discussed in the DPI's supporting paper. The Expert Panel noted these challenges by commenting that the TFP approach is not an exact science<sup>4</sup>:

"TFP estimation might itself be characterised as involving as much 'art' as hard science, and it could not reasonably be expected that regulators and service providers will reach ready agreement on the precise approach and its outcomes."

From SP AusNet's perspective, the principal challenges to developing a successful TFP approach are:

- **Data quality and the selection of an appropriate data set or peer group.** A particular concern for SP AusNet is that Victorian companies have performed well

<sup>1</sup> DPI, Proposed Rule change to the Australian Energy Market Commission to permit the use of the TFP approach, May 2008, page 39.

<sup>2</sup> Ibid, page 42.

<sup>3</sup> Ibid, page 44.

<sup>4</sup> Ibid.

over the last 10 years and should not be disadvantaged by comparisons with interstate companies that are “catching up”.

- **The modelling of TFP is likely to be controversial.** Whilst the concepts underpinning TFP are not complex, its application is typically undertaken by experts and is likely to be highly technical. For example, distribution networks do not produce easily measured outputs or units of production, whilst inputs largely comprise fixed assets that could be valued and costed in numerous ways. Therefore, determining a sector’s TFP (which is the ratio of outputs to inputs) is likely to raise complex issues that could be addressed through different, but equally valid approaches that would deliver different outcomes.
- **Price and cost divergence.** Simply put, the stronger incentive powers of a TFP regime also create risks for all parties if significant and sustained divergences between costs and prices emerge over time. For this reason, there is a need for a mechanism to bring prices and costs back into alignment if the divergence becomes too great. The DPI’s Rule change proposal seeks to check calibration at the start by conducting a “building block assessment” for year 1, and the DPI also suggests that cost pass-through provisions may be appropriate. However, the DPI has rejected an equally valid method for managing the risk of price-cost divergence, which is for off-ramps to re-calibrate prices during the control period.

Given these fundamental challenges, or concerns, SP AusNet’s view is that the Rules should not ‘hard-wire’ the detailed mechanics of how the TFP approach should operate. In particular, the Rules should balance the conflicting objectives of:

- providing sufficient flexibility on the detailed design issues (including, appropriate use of data; transitional issues; and S-factor arrangements) to ensure that company-specific and jurisdictional issues are addressed appropriately on case-by-case basis; and
- providing DNSPs with sufficient regulatory certainty regarding the AER’s application of the TFP approach, so that DNSPs can invest confidently in their networks.

Clearly, these objectives are somewhat in conflict because greater regulatory certainty implies less flexibility. SP AusNet notes that in relation to many issues, the DPI Rule change proposal adopts an appropriate balance between these objectives. However, SP AusNet has identified a number of areas where SP AusNet believes that some modifications to the DPI’s proposal would be appropriate. These issues are explained in detail in section 3 below.

### **3. Key issues for SP AusNet**

#### **3.1 TFP approach should be a genuine alternative to building block regulation**

As noted in section 2 of this submission, SP AusNet’s view is that the appropriate application of the TFP approach could deliver substantial benefits to customers and the industry. Whilst the DPI’s Rule change proposal is also predicated on this view, it

is evident from the DPI's supporting paper and the draft Rules that the building block approach would continue to be the primary form of regulation.

In particular, the regulatory framework proposed by the DPI effectively reverts back to a cost of service building block approach, undermining the attractiveness of a TFP approach for businesses, and the mutual benefit that would be created for customers. It also creates a duplication of administrative effort by regulators. In SP AusNet's view, the frequent re-setting of prices to reflect costs would substantially reduce the potential benefits of the TFP approach as noted by the Expert Panel in identifying "best practice" elements for a TFP price control setting method to be included in guidance<sup>5</sup>:

"This guidance should include the need for a TFP control setting method to ensure:

- [3<sup>rd</sup> bullet] the abolition of any specification of the minimum (or maximum) regulatory period. An important benefit of a TFP approach to control setting is the potential flexibility to set longer regulatory periods than the current five year approach, perhaps in conjunction with the use of off-ramps linked to whether or not actual rates of return are within a prescribed band"

SP AusNet concurs with the Expert Panel's view that the mechanisms for updating price controls under the TFP approach are critical to the success of the TFP approach<sup>6</sup>:

"Of equal if not greater importance is to develop the rules that are to be applied in updating price controls that have been determined under this approach. This involves addressing in very specific detail issues such as:

- For what duration should the control be fixed?
- Will there be triggers for updating either initial prices ('P<sub>0</sub>') or X estimates (off ramps) and what form will they take?
- Under what circumstances will the initial prices be adjusted (or not adjusted) so as to be brought into line with costs when a TFP-based price cap is reviewed?
- How might service incentive mechanisms be incorporated into both the design of off-ramps, and the P<sub>0</sub> reset process?
- How will decisions on each one of the above design parameters take account of the incentive and other effects?"

SP AusNet would encourage the Commission to ensure that new Rules giving effect to the TFP approach provide a genuine alternative to building block regulation. As presently drafted, SP AusNet believes that the Rule change proposal tends to use building block regulation as a reference point for judging the efficacy of the TFP approach. The practical implication of the approach outlined in the DPI's proposal is that DNSPs would continue to be required to prepare forecast information, and the AER would continue to be required to review it.

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<sup>5</sup> Expert Panel on Energy Access Pricing, April 2006, page 109.

<sup>6</sup> Ibid, page 104.

Ideally, SP AusNet's view is that there should be no need for prices to be referred back to actual costs once the scheme is operational. SP AusNet notes that the DPI appears to share this longer term goal<sup>7</sup>:

"The model for the TFP approach that is proposed in this submission includes a requirement for price controls to be reset with reference to cost at pre-determined intervals (with the interval to be determined by the AER, having regard to specified criteria, as at present). While a regulatory approach whereby there was no pre-determined time at which prices are reset with reference to cost may be an optimal regulatory approach to consider over the longer term, requiring a pre-determined cost-based review in the initial version of the TFP approach would minimise the risk to regulated businesses and customers from unforeseen outcomes under the TFP approach as the technique is being refined."

Whilst SP AusNet accepts that this ideal approach may not be immediately attainable, SP AusNet considers that reverting to a resetting of starting prices should arise from an identified need, even in the initial version. The Expert Panel proposed a way of considering this issue<sup>8</sup>:

"On the other hand, the efficiency incentives in a TFP-based price cap plan can be reduced by the adoption of a shorter regulatory period, thereby limiting the term over which a service provider may benefit from any efficiency gains. However, this form of incentive dilution can itself be offset by, say, committing not to reset starting prices for the next regulatory period unless they fall outside a prescribed band".

It is important that the Rules provide a clear path for achieving the objective of a price path established by reference to industry wide growth in productivity and inflation, which, in turn, requires a more limited linkage to building block regulation than currently envisaged in the draft provisions.

### **3.2 Satisfying the National Electricity Law requirements**

The National Electricity Law ("NEL") sets out the criteria the Commission must apply when considering a proposal for a Rule change, as well as the various procedural requirements it must follow. In particular, section 88(1) of the NEL provides that the Commission may only make a Rule if it is satisfied that the Rule will or is likely to contribute to the achievement of the national electricity objective in Section 7 of the NEL, which is:

"The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to—

- (a) price, quality, safety, reliability and security of supply of electricity; and
- (b) the reliability, safety and security of the national electricity system."

<sup>7</sup> DPI, Proposed Rule change to the Australian Energy Market Commission to permit the use of the TFP approach, May 2008, page 7.

<sup>8</sup> Expert Panel on Energy Access Pricing, April 2006, page 102.

In addition, the Commission is required by section 88B to take account of the revenue and pricing principles, which are set out in Section 7A of the NEL, which includes the following provision:

A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in—

- (a) providing direct control network services; and
- (b) complying with a regulatory obligation or requirement or making a regulatory payment.

It is interesting to note the DPI's interpretation of these provisions in its supporting paper<sup>9</sup>:

“The important issue for whether the TFP approach is sustainable – and meets the requirements of the NEL – is whether the TFP approach provides an individual firm with a reasonable opportunity to recover at least its efficient costs. This requirement clearly is met with the building block approach, as the price controls for each regulatory period are determined on the basis of forecasts of the firm's own costs. As explained further below, the basis for the TFP approach is a proposition that prices should track a firm's unit cost, which in turn will depend upon that firm's future total factor productivity growth and input-price inflation.

However, to make the TFP approach operational – and to achieve the reduction in the administrative costs of regulation as intended – it is necessary to use measured productivity growth for the industry as the proxy for the individual firm's forecast productivity growth. Whether historical, industry-wide productivity growth will provide a reasonable proxy for the future productivity growth of an individual firm will depend upon the circumstances of that firm, including its operating environment.

A central feature of the TFP approach, therefore, is how the model addresses the situation of firms for which this requirement is not met. The two potential responses to this issue are either to:

- ‘tailor’ the estimate of the future productivity growth for a particular firm to take account of the specific circumstances facing that firm; or
- to ensure that the NEL objective is met by limiting the application of the TFP approach, namely only to firms for which historical, industry-wide productivity growth is a reasonable proxy for the future productivity growth of an individual firm.

The second of these approaches has been adopted in the TFP approach that is proposed here.”

Whilst SP AusNet agrees with DPI that it is essential that DNSPs have an opportunity to earn a reasonable rate of return, SP AusNet does not support the DPI's application

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<sup>9</sup> DPI, Proposed Rule change to the Australian Energy Market Commission to permit the use of the TFP approach, May 2008, page 13.

of this principle as described in the above quotation. In particular, the DPI explains that its Rule change proposal (clause 6A6.6(f)(2)) would<sup>10</sup>:

“preclude the TFP approach from being applied where the productivity growth for the distributor in question is expected to be materially different to that of the industry as a whole.”

SP AusNet notes that the DPI’s approach is based on the presumption that providing DNSPs with ‘a reasonable opportunity to recover at least its efficient costs’ requires a consideration of, or proxy for, the particular DNSP’s future productivity improvements. On the contrary, however, SP AusNet’s view is that setting prices with reference to industry averages mirrors the operation of a competitive market. Competitive markets evidently provide all participants with ‘a reasonable opportunity to recover at least its efficient costs’, even though market prices are not tailored to reflect the particular costs or productivity of each firm. Importantly, therefore, SP AusNet considers that setting prices with reference to industry averages would not necessarily be inconsistent with the pricing and revenue principles in the NEL.

In contrast to the DPI’s position, SP AusNet’s view is that the national electricity objective may be better achieved if the TFP approach consciously adopted an industry-wide, rather than a firm-specific focus. As noted in section 3.1 of this submission, the DPI’s desire to align prices and costs will necessarily involve a similar set of issues (and costs) as those that arise under building block regulation.

### **3.3 Rolling X factors, off-ramps and cost pass-throughs**

An important operational aspect of the TFP approach is the question of how prices should be adjusted during the regulatory period to reflect new information regarding company costs or productivity improvements. In its supporting paper, the DPI explains that a method that has been used for allowing for the possibility that productivity growth may change over time – and so maximising the extent of up-to-date information on productivity growth – is through using what is known as a ‘rolling X factor’. Essentially, a rolling X factor updates the calculation of X to reflect the latest information on productivity growth. A rolling X factor contrasts with a fixed X factor, which is set during a regulatory review and is not updated until the next regulatory review.

There are two other broad mechanisms for adjusting prices during a regulatory period to reflect new cost information:

- an earnings-based re-opening (often referred to as an ‘off-ramp’) – which typically involves specifying a permitted range for the rate of return earned on the regulatory asset base, with a resetting of prices if the rate of return falls outside this range; and
- cost pass through – under which the prices can be adjusted to allow the distributor to pass through the costs associated with specified, exogenous events, such as a change in input taxes, with the effect being that prices are adjusted upward (or

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<sup>10</sup> Ibid, page 39, also see draft clause 6A6.6(f)(2).

downward if there is a favourable change) by the estimated cost-effect of the event, but the underlying level of prices is not reviewed.

It is evident that a rolling X factor, off-ramps and cost pass-through arrangements are broad substitutes for one another. In its supporting paper, the DPI explained that care must be taken to ensure that these mechanisms used in combination deliver appropriate outcomes<sup>11</sup>:

“However, if the ‘rolling X factor’ is used as proposed, then care must be taken to ensure that the application of the pass through does not result in double-counting (i.e., by compensating for the cost increase and also through the pass through). To address this potential, it is proposed that the measurement of total factor productivity exclude the effect on measured input growth from events that give rise to a cost pass-through so that all of the cost could be reflected in the cost pass through. In contrast, as the fixed X factor is fixed throughout the regulatory period, then no potential for double counting during the regulatory period as a result of the pass through application would exist.”

The DPI’s Rule change proposal would provide DNSPs with a choice between rolling and fixed X factors, but in relation to off-ramps and cost pass through arrangements, the DPI concludes:

“Turning first to earnings-based re-openers, while the Expert Panel noted that these were often a feature of TFP approaches in the United States, it is proposed that such a re-opener not be permitted in the version of the TFP approach proposed here. Earnings-based re-openers have the effect of reducing the power of incentives for the regulated business to be efficient (by capping the level of benefit or loss that may be suffered), but do so in order to increase the degree of assurance that regulated businesses will recover their costs as well as minimising the risk that regulated businesses may receive an excessive share of the benefit of efficiency gains. In the version of the TFP approach proposed in this submission, there are already appropriate mechanisms for minimising the risk of such inappropriate outcomes, which have been common features in applying incentive regulation in Australia, including:

- the requirement for prices to be reset at cost at a pre-determined time in the future; and
- the continued ability for cost pass throughs to occur for specified, exogenous events (albeit in a modified form).”

SP AusNet questions the reasoning presented in the above quotation. Firstly, the power of the incentives would be greatly improved if longer (or indefinite) regulatory periods were adopted. Secondly, for longer regulatory periods, off-ramps provide a low-cost mechanism for ensuring that the net effect of any unexpected input cost and productivity changes are shared appropriately between the company and its customers. SP AusNet’s view, therefore, is that the Rules should be sufficiently flexible to allow DNSPs to choose between off-ramps and pass-through arrangements. SP AusNet strongly supports the DPI’s view that DNSPs should be able to choose between rolling and fixed X factors.

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<sup>11</sup> Ibid, page 26.

### 3.6 Opt in and Opt out discretion

From SP AusNet's perspective, it would be unacceptable if the Rules created a situation where TFP could be imposed on SP AusNet by the AER or any other party. The reason for this concern is simply that the methodology itself is untested in Australia and its application is not simple or uncontroversial. The outcomes from TFP therefore remain highly uncertain until relevant and accurate data are sourced and applied in an appropriately designed model. SP AusNet therefore welcomes the DPI's proposal to require the distributor to consent to the application of the TFP approach for the first time.

SP AusNet is concerned, however, that the DPI proposes that once network businesses have become subject to TFP (albeit at their discretion) then they would not have singular discretion to opt out at a future pricing reset, on the basis that this would be condoning opportunistic behaviour. The DPI therefore proposes that opting out would require AER agreement. SP AusNet considers that the option for a business to opt out without dependency on the AER's view of the financial position of the business is a necessary safe harbour. This issue is discussed further in section 4 of this submission.

### 3.7 Administrative process

SP AusNet notes that clause 6.8.1(f) of the existing Rules states:

"If a distribution determination is currently in force, the *AER* must commence preparation of, and consultation on, the *framework and approach paper* for the distribution determination that is to supersede it at least 24 months before the end of the current *regulatory control period* and must complete preparation at least 19 months before the end of that *regulatory control period*."

SP AusNet is strongly of the view that the DNSPs in Victoria should have an opportunity to adopt TFP regulation in the next review (which is scheduled to be completed before December 2011). With this objective in mind, the timeframes in clause 6.8.1(f) may prove to be too onerous if all the relevant TFP matters are canvassed in the *framework and approach paper*. As an alternative approach, SP AusNet's view is that the Commission should consider an arrangement whereby the TFP model should be developed by the AER in a standalone guidance paper.

On this basis, the Rule change would not necessarily be required to be in place to be strictly within the timeframe provided for the *framework and approach paper*. Nevertheless, SP AusNet believes that the TFP model would need to be finalised by early 2009 in order for the Victorian network businesses to consider whether to adopt the TFP model and provide the necessary information in their proposal to the AER for a pricing determination.

#### 4. Assessment of the draft Rules

The table below highlights those provisions where SP AusNet's view differs from the approach proposed by the DPI. Several of the provisions identified in the table have been discussed already in section 3 of this submission.

Clause	Overview of provision	SP AusNet's assessment
6.2.4A(d)	<p>If the <i>AER</i> decides to apply the total factor productivity methodology, a <i>Distribution Network Service Provider</i> may not thereafter revert to the building blocks approach for subsequent <i>regulatory control periods</i> unless the <i>AER</i> consents. In deciding whether to give its consent the <i>AER</i> must have regard to the matters set out in paragraph (b).</p>	<p>SP AusNet does not believe that there is any sound economic or regulatory rationale for denying a request from a DNSP to adopt building block regulation after that DNSP has been subject to TFP regulation. Building block regulation accords with the national electricity objective, and aims to ensure that a regulated company has a reasonable expectation of earning its cost of capital over the regulatory period. It is difficult to understand why the <i>AER</i> should have discretion not to apply this form of regulation if the DNSP requests it.</p>
6.6A.3(a) and (b)	<p>(a) The purpose of paragraph (b) of this clause is to set out the criterion ("the TFP criterion") which the <i>AER</i> is to have regard to in order to assess the calculations required by clauses 6.6A.5 and 6.6A.6.</p> <p>(b) The tariffs for the first <i>regulatory year</i> of a <i>regulatory control period</i> and the X factor for that and subsequent <i>regulatory years</i> in combination should permit a <i>Distribution Network Service Provider</i>, whose total factor productivity growth is the same as that assumed in calculation of the X factors, to recover at least its efficient costs over the <i>regulatory control period</i>.</p> <p>The DPI supporting paper (page 22) further explains that the role of the TFP criterion that has been proposed is merely to require a test of the consistency of the calculation, so that the intended result – that prices track unit cost – is achieved if all of the inputs or assumptions (e.g., that the X factor accurately reflects expected future productivity growth) are correct.</p>	<p>SP AusNet notes that the DPI's supporting paper (page 22) indicates that the criterion is principally focused on ensuring that various issues such as asset valuation and depreciation are addressed consistently in the TFP and X factor calculations.</p> <p>However, SP AusNet is concerned that as drafted the criterion does not provide a clear indication of its intended purpose. As presently drafted, the proposed criterion provides no guidance to the <i>AER</i> because it is tautological – it simply states that if a DNSP's performance is the same as assumed in the X factor calculation, then the DNSP should at least recover its efficient costs.</p> <p>The lack of clarity of the proposed criterion coupled with the calculations described in 6.6A.5 and 6.6A.6 provide the <i>AER</i> with inappropriately broad discretion to make adjustments to the initial tariffs (see for example 6.6A.5(b)(6)). SP AusNet notes, in particular, that the setting of the initial tariffs in a TFP approach is equally important to the setting of the X factor. If wide discretion is afforded to the <i>AER</i> in setting the initial tariffs, the potential benefits of the TFP approach could be compromised.</p>

Clause	Overview of provision	SP AusNet's assessment
6.6A.4	<p>When determining whether a <i>regulatory control period</i> of more than 5 <i>regulatory years</i> should be specified, the <i>AER</i> must also have regard to the extent to which the particular <i>X factor method</i> used makes it more or less likely that over the <i>regulatory control period</i> tariffs will, or are likely to, reflect the efficient costs of the <i>Distribution Network Service Provider</i>.</p> <p>Note: See clause 6.6A.6 which sets out the two alternative <i>X factor methods</i>. The longer a <i>regulatory control period</i>, the greater the possibility - if the <i>fixed X factor method</i> is used - that tariffs will trend away from a <i>Distribution Network Service Provider's</i> efficient costs. This possibility is lessened if the <i>rolling X factor method</i> is used at the same time as a more lengthy <i>regulatory control period</i>.</p>	<p>This draft provision (and the accompanying note) is focused solely on matching costs and revenues of the particular DNSP. SP AusNet notes that a narrow focus on matching costs and revenues will necessarily drive the AER to a shorter regulatory period. Importantly, however, a key benefit of TFP regulation is that it has the potential for costs and revenues for a particular DNSP to diverge because that company achieves and sustains cost efficiencies and service improvements that exceed the industry average. Naturally, there is a tension between providing stronger incentives to achieve efficiency improvements (through a longer regulatory period) and sharing those efficiency improvements with customers. SP AusNet's view is that the AER should consider this trade-off when determining the length of the regulatory period.</p> <p>SP AusNet recognises that the notes to this provision imply that a longer regulatory period should be accompanied by a rolling X factor. SP AusNet does not accept this proposition. A rolling X factor imposes substantial risk on the DNSP because it exposes the company's revenue to annual assessments of the X factor by the AER and its consultants. An unpredictable regulatory process of this kind is not desirable, and becomes totally unacceptable if the regulatory period is extended.</p> <p>In addition, SP AusNet considers that a more genuine alternative to the building block regime would provide for the applicable X factor to be redetermined independent of the need to consider redetermine initial tariffs. As noted in section 3.1, it would be more appropriate to redetermine initial tariffs on the basis of prices falling outside of acceptable bands.</p>

Clause	Overview of provision	SP AusNet's assessment
6.6A.5(c)	<p>Where the total factor productivity methodology is to be applied in a regulatory control period (the "subsequent total factor productivity regulatory control period") that commences immediately after a regulatory control period (the "prior total factor productivity period") in which the total factor productivity methodology has been applied:</p> <p>(1) the initial tariff for a standard control service; or</p> <p>(2) where the control mechanism is tariff basket price control, the initial tariffs in the basket of tariffs for standard control services shall be determined by the AER for the subsequent total factor productivity regulatory control period as follows:</p>	<p>SP AusNet finds it difficult to identify the principles for the determination of initial tariffs. Whilst the building block approach is envisaged the clause also seems to imply that an equating of revenue to actual cost is necessary. This approach would tend to firm specific costs to a level not applied even under building block regulation which combines firm specific operating and capital expenditure estimates with a number of benchmarked elements.</p> <p>Our conclusion is that the drafting of provisions for the initial tariff setting requires careful consideration.</p>
6.6A.6(c)	<p>The X factor for each <i>regulatory year</i> shall be determined by the AER in accordance with the following formula:</p> $X = \text{growth TFP for the industry} - (\text{CPI growth} - \text{Input Price growth for the industry})$	<p>SP AusNet notes that the DPI's supporting paper explains (footnote 19, page 16) that the X factor calculation can also be expressed as:</p> $X = (\text{TFP growth for the industry} - \text{TFP growth for the economy}) - (\text{Input Price growth for the industry} - \text{Input Price growth for the economy})$ <p>SP AusNet's view is that the Rules should not be drafted narrowly as proposed in clause 6.6A.6(c). Instead, both forms of the X factor calculation should be set out in the Rules. This will aid understanding and provide an opportunity to test and verify the X factor calculation.</p>

Clause	Overview of provision	SP AusNet's assessment
6.6A.7	<p>The AER may, in accordance with the <i>distribution consultation procedures</i>, develop and <i>publish</i> a scheme or schemes (<i>efficiency benefit sharing scheme</i>) that provide for a fair sharing between <i>Distribution Network Service Providers</i> and <i>Distribution Network Users</i> of:</p> <ul style="list-style-type: none"> <li>(1) the efficiency gains arising from the growth inputs in a <i>regulatory control period</i> being less than the growth inputs assumed for that <i>regulatory control period</i>; and</li> <li>(2) the efficiency losses arising from the growth inputs in a <i>regulatory control period</i> being more than the growth inputs assumed for that <i>regulatory control period</i>.</li> </ul>	<p>SP AusNet supports the proposal to consider whether TFP regulation should be accompanied by an efficiency benefit sharing scheme. However, the draft provision is somewhat confusing because it unnecessarily equates differences between forecast and actual growth inputs with efficiency gains or losses. This is incorrect because productivity or efficiency improvements depend on the relationship between inputs and outputs, rather than the relationship between forecast and actual inputs. SP AusNet would prefer more flexible drafting for this provision.</p>
6A.9.2	<p>The drafting of this provision is not particularly clear, but it appears that a DNSP will only have 30 business days to submit a building block proposal if the AER finds that a TFP approach should not apply (following the submission of a TFP proposal from the DNSP).</p>	<p>SP AusNet notes that it would be impractical for a DNSP to produce a compliant building block proposal within 30 business days. An important potential benefit of the TFP approach (as noted in the DPI supporting paper) is that detailed cost forecasts and supporting information are not required. It would be disappointing - and contrary to the DPI's stated goal of reducing the administrative cost of regulation - if the regulatory process effectively required DNSPs to prepare a 'back-up' building block submission in order to meet the 30 business day timetable.</p>

## 5. Concluding comments

SP AusNet strongly believes that including provisions that enable DNSPs to elect to be subject to TFP regulation would provide an important improvement to the existing Rules. This is because in broad terms, TFP provides a means of delivering substantial benefits to customers and regulated companies through the provision of more powerful incentives and the lowering of costs associated with regulation. SP AusNet therefore supports the DPI's initiative to propose a Rule change to permit the adoption of TFP regulation.

This submission has focused on a relatively small number of important matters where SP AusNet's views differ from those underpinning the proposal developed by the DPI. One particular point of principle is SP AusNet's view that the TFP approach should be a genuine alternative to building block regulation and, as such, the Rules should not regard building block regulation as the yardstick by which outcomes from the TFP approach ought to be measured. SP AusNet therefore recommends that the Commission should consider a relatively small number of important amendments - noted in this submission - to the proposed Rule change to ensure that the potential benefits of the TFP approach can be realised.

SP AusNet welcomes the opportunity to make this submission to the Commission, and we would be pleased to discuss this submission in further detail with you at your convenience.

Yours sincerely,



Kelvin Gebert

**MANAGER REGULATORY STRATEGY AND COMPLIANCE**