

24 December 2010

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

Dear John,

AEMC's Review of Total Factor Productivity (TFP): Draft Report

SP AusNet welcomes this opportunity to comment on the Commission's Draft Report on the potential for TFP to be applied as an alternative form of regulation. Throughout this review SP AusNet has supported the exploration of an alternative option to building block regulation for the gas and electricity distribution sectors. The Draft Report's conclusion that TFP-based regulation for distribution is consistent with the National Energy Objectives is an important step forward in providing an alternative form of regulation.

SP AusNet acknowledges the Commission's reasons for introducing rules to commence the collection of data to support the future application of TFP. These rules and subsequent data specifications should be developed in close consultation with industry. The means by which the data is collected by the Australian Energy Regulator (AER) should be streamlined with existing regulatory instruments as much as possible to minimise additional costs and maximise efficiency. Given that the Commission has found it unlikely that TFP would be appropriate for transmission, different information collection arrangements should apply.

The lack of a specific TFP methodology and implementation strategy in the Draft Report leaves many TFP design issues unresolved and industry unclear as to how TFP regulation could be expected to work in practice. Clarity around certain design and implementation issues is necessary to address potential regulatory uncertainty in relation to the Commission's proposal.

This submission provides our response to a number of findings in the Draft Report and comments on Stage 1 and Stage 2 implementation issues which should be addressed in the Final Report to ensure that progress is made towards an appropriately designed and governed TFP regime.

We would be pleased to respond to any queries that you may have, and look forward to participating constructively in the next stage of the Commission's review.

Yours Sincerely

A handwritten signature in blue ink, consisting of stylized initials 'AP' followed by a long horizontal flourish.

Alistair Parker

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1. Overview

SP AusNet supports the Draft Report's conclusion that TFP-based regulation for distribution is consistent with the National Energy Objectives. However, some important issues which have been debated throughout this review remain unaddressed in the Draft Report. This submission, therefore, responds to the findings of the Draft Report and argues that the Final Report should resolve some of these outstanding issues.

This submission separates issues which we consider should be resolved at Stage 1 and Stage 2 of this review. These issues are:

Stage 1

- Findings against the Energy Objectives, including the applicability of TFP to transmission;
- Information collection, including specifying data requirements and differentiating distribution from transmission;
- Clarifying the methodologies to be used in assessing conditions to support TFP;
- Opting in to TFP-based regulation; and
- Arrangements for the initiation of Stage 2.

Stage 2

- Deciding on a TFP methodology design to be codified in Rules.

Each of these matters is addressed in turn below.

2. Stage 1 TFP Review and Rule Change

2.1 Findings against the Energy Objectives

SP AusNet welcomes the Draft Report's conclusion that TFP-based regulation for distribution is consistent with the National Energy Objectives. TFP-based regulation, when designed appropriately, can provide a genuine opportunity to deliver a lower cost regulatory regime, and drive network businesses to achieve further cost savings and service improvements. From a policy-making perspective, a sound TFP regime would not only provide stronger incentives for businesses to perform well and earn above average returns, but also deliver lower prices to consumers over the longer term.

However, the success of TFP-based regulation will depend on its design. As such, a fully detailed TFP design proposal should be articulated in Stage 2 of this review, which will convert TFP principles into a transparent TFP methodology. This is necessary to ensure that the resulting regime is transparent and well understood before it is codified in the regulatory framework.

SP AusNet supports the Commission's finding that TFP-based regulation is unlikely to be suitable for the economic regulation of transmission. While the available evidence goes against the application of TFP-based regulation for transmission SP AusNet understands

that the Commission wants to be completely assured that TFP would not work in transmission before ruling it out. Regardless, this finding should be factored into the data collection arrangements for TNSPs. In particular, the specification of distribution TFP data should take priority over transmission data. SP AusNet has developed a suggested approach in section 2.2 of this submission.

The Draft Report recommends the initial Rule to facilitate the future implementation of TFP should cover the following areas:

- Collecting necessary data for a TFP methodology;
- Requiring the AER to collect TFP data and publish annual TFP data and index calculations;
- Using TFP data to test TFP methodology issues;
- Conditions to be met before TFP can be applied; and
- Principles for the design of a TFP methodology.

Issues related to these recommendations are addressed below.

2.2 Information provision obligations and data requirements

Additional information provision requirements

The Draft Report proposes to place an obligation in the Rules on service providers to provide the necessary TFP data in addition to the AER's existing information gathering powers. It is intended that this explicit requirement will provide authority for the AER to collect data for the purposes of TFP assessment. The Commission does not envisage that the cost of providing this data will be substantial, despite the possibility that businesses may need to develop new IT and information systems to report against TFP measures.

SP AusNet acknowledges the Commission's reasons for introducing rules to facilitate the collection of TFP data. However, SP AusNet refers the Commission to the concerns set out in the Energy Network Association's (ENA's) submission in relation to the use of Rules to expand the AER's information collecting powers beyond those provided in the National Energy Law.

Data specification

The Draft Report sets out the following proposal to include data specification requirements in a schedule in the gas and electricity rules:

The requirements and definitions will be specified in a schedule to the NER and NGR. This will include financial, asset and network operational data.

[including] an obligation on the AER to develop supporting guidelines to assist in the information disclosure process. The AER will be required to establish a working group

with industry representatives on the detailed coverage and specification of the required data.¹

SP AusNet's view is that the Rules should provide an appropriate level of guidance to the AER's discretion. Therefore, in addition to the Commission's proposal that the AER establishes an industry working group to develop detailed data specifications, SP AusNet supports a clearly articulated decision-making process to guide the development of the data sets to ensure that the specifications are properly informed and useful. If this decision-making process was included in the Rules, it would be sufficient for the Rules to broadly outline the scope of data required, rather than set out detailed data specifications. Further, a properly informed and determined set of data specifications which had the input and support of industry would reduce the need for any data cleansing or adjustments at the later condition testing stage.

SP AusNet agrees with the Commission that the basis for the development of the detailed specifications could be informed by the wide-ranging data groups set out in Appendix E of the Preliminary Findings Paper.² However, the AER, in consultation with the industry working group, would need to assess whether the respective data sets are necessary, available and appropriate.

Methodology used in AER assessment of conditions to support TFP

SP AusNet supports the TFP principles and conditions set out by the Commission in the Draft Report in relation to the future TFP methodology to be applied and the conditions required to trigger Stage 2 of the review.

However, it is questionable how data specifications could be developed without an understanding of the conditions which the data will be used to assess. Therefore the scope of the TFP working group and AER Guidelines should include defining the tests for determining whether the conditions for TFP have been met, particularly:

- if service providers within the industry group have comparable expectations of productivity growth; and
- whether a TFP index is a good estimate of future productivity growth.

These two conditions are particularly contentious as they are potentially open to interpretation. As such, the tests to be used to assess them need to be carefully defined and rigorous.

It is also important for further detail about the potential methodologies to be used by the AER in assessing the conditions to support TFP to be included in the Rules in addition to the proposed TFP principles. This would provide some further guidance and certainty about how the TFP conditions assessment is to be made. For example, key design issues such as the length of regulatory periods, articulation of the formula used to calculate the TFP index and how the TFP index is to be updated each year should be captured.

¹ AEMC, TFP Review: Draft Report, November 2010, p 94-95

² AEMC, TFP Review: Draft Report, p 97

It would be logical for the methodologies to be used in assessing the conditions to support TFP regulation to build upon the extensive work completed by the Commission to date and be based upon the different TFP designs debated at previous stages of this review, rather than starting afresh and duplicating work. Therefore the Final Report should recommend the Rules require the AER to use the various TFP designs contemplated in this review as a starting point to developing an appropriate methodology for assessing conditions to support TFP.

Further, rather than having the assessment of TFP conditions be an ongoing responsibility for the AER to undertake on an ad hoc basis, it would be useful for a formal decision making process to be undertaken to determine whether conditions have been met. This would:

- start with the working group assisting the AER in developing data specifications;
- continue through to deciding on TFP methodologies to be used (having regard to those methodologies and design elements set out in the Rules); and
- extend to testing for conditions and analysing the outcomes of the conditions assessment.

Streamlining TFP data information requirements

In the interests of minimising the costs and burden involved in providing TFP data, and maximising efficiency in data collection processes, any additional information requirements should be streamlined as much as possible with existing instruments and processes. For example, TFP data could be collected as part of the AER's distribution regulatory information order (RIO) which is intended to set out a nationally consistent framework for annual information reporting by DNSPs. As stated in the AER's Discussion Paper

The AER considers that publication of the RIO, including the annual reporting templates, will contribute to the achievement of the national electricity objective by providing the AER with the information it reasonably requires to carry out its regulatory functions. The AER will use the information to be collected under the RIO to assist in the assessment of future regulatory proposals by DNSPs and make distribution determinations. Collecting such information annually will enable the AER to assess DNSPs' performance during the course of a regulatory control period leading to enhanced analysis of the data. The information collected will also be used by the AER in its other regulatory functions as set out in section 15 of the NEL, where relevant.

*The RIO will contain annual reporting templates to be populated by DNSPs...*³

Given that the AER is still developing the RIO to capture regulatory data in a nationally consistent manner, the RIO presents an opportunity to develop a single instrument to capture TFP reporting requirements as well as those used for annual regulatory reporting.

³ AER, Electricity distribution network service providers: Annual information Reporting Requirements Issues Paper, August 2008, p 1

TFP data provision in transmission

The Commission's proposed Rule for information collection will oblige all regulated distribution and transmission (electricity and gas) service providers to submit an annual disclosure of regulatory information to the AER. SP AusNet is disappointed that despite finding that TFP is unlikely to be appropriate for transmission, the Commission has decided that TNSPs should be subject to TFP data collection:

...Although we found that it is unlikely to be appropriate to implement a TFP methodology in the transmission sectors, the issues with the building block approach identified during this Review apply equally to both transmission and distribution. Therefore the developing of robust and transparent regulatory data sets for transmission will potentially improve the application of economic regulation in these sectors as well.⁴

It is envisaged that this data will allow for a TFP methodology to be tested to determine if the relevant conditions will be met for the electricity transmission sector and conclude if TFP could apply to transmission as well as assist in addressing information asymmetry issues and boost the rigour of building block decisions.

The weight of evidence against the application of TFP-based regulation for transmission – including the absence of this form of regulation in other countries - demonstrates it is unnecessary to collect TFP data in order to draw the conclusion that TFP would not suit the transmission sector. Further, the data currently provided by TNSPs is appropriate for the purposes of the building block regime. In addition, the AER already has substantial powers to collect the information that it considers necessary to support the revenue-setting process (which may include benchmarking information). SP AusNet shares Grid Australia's view that TFP-based and building blocks regulation are distinct regimes and it would not be appropriate to mix them in terms of their application or data collection. As such, a rule change to introduce further information requirements on TNSPs to provide TFP data is not warranted.

However, if the Commission requires greater evidence to support a finding that TFP should not apply to transmission, then the following alternative approach is preferable:

- (a) Data specification for TFP-based regulation should be developed first for the distribution network companies as a matter of priority.
- (b) Following this, TNSPs would work with the AER to determine the data that would be required to support the potential application of TFP-based regulation to the transmission sector. The AER will determine at the data specification stage whether the specified data is likely to produce a TFP-index which satisfies the Commission's conditions. The AER would only collect the data if these conditions were expected to be satisfied.
- (c) In addition to (b) above, the AER would specify additional data to support its application of building block regulation. It should be noted that this data specification may be different to the data specification for TFP-based regulation.

⁴ AEMC, TFP Review: Draft Report, p 95

2.3 Opting into TFP

Businesses should have the ability to opt in and out of TFP-based and building block regulation for there to be genuine and effective alternative forms of regulation in the Rules. As the alternative regulatory regimes should each be fit for purpose and consistent with promoting the National Energy Objectives, there is no basis to restrict a distributor's ability to choose between the alternative regimes.

Any restriction on a business' ability to move between regimes will create uncertainty and risk. For example, if it is contemplated that the application of TFP would be mandatory this would be a significant change to the regulatory framework, and would fundamentally undermine the principle of regulatory certainty. Similarly, few businesses would risk moving to a new TFP-based regime if restriction applied to returning to the building block regime.

The public policy impact of removing the ability for a business to decide when TFP would be applied would be to compromise the legitimate commercial interests and sovereignty of businesses and undermine the 'regulatory compact' between policy-makers and regulated businesses. This risk was recognised in the Victorian Government's TFP Rule Change proposal where it was noted:

...a further measure to protect the legitimate business interests of regulated distributors is proposed. Given the fact that the TFP approach would be a new and as yet untested regime for Australian energy businesses, it is proposed to require the distributor to have proposed (and hence consent to) the application of the TFP approach before it is applied for the first time. The AER would need to accept that the TFP approach was appropriate – applying criteria to the type described above – but would not be permitted unilaterally to impose the TFP approach.⁵

SP AusNet reiterates that the possibility of having TFP imposed upon businesses would make the introduction of TFP-based regulation (a new and untested regulatory approach in Australia) too risky.

While the ability to adopt a TFP approach is a key issue which requires resolution in Stage 1 of this review, the Draft Report makes no recommendations on this issue. There are implications in the Draft Report that businesses would be able to choose between building blocks and TFP but despite it being an agreed principle throughout this review to date, there is no explicit recommendation on the matter. In one section the Draft Report states:

*That is, even if a TFP methodology is not ultimately included in the NER or NGR **or, if the methodology is not selected by service providers**, the collection of relevant, robust data using consistent definitions is an important part of cost effective economic regulation. [our bolding]⁶*

However, the Commission appears to be undecided on whether TFP-based regulation should be regarded as a regulatory option that could work in parallel with building blocks:

One issue with introducing a TFP methodology as an alternative to building blocks regulation is that it could lead to having two alternative forms of regulation working in parallel. While this adds to the flexibility of the regulatory regime, it will add to transaction costs and creates possible gaming incentives. Further consideration of

⁵ Victorian Government TFP Rule Change Proposal, pp 20-21

⁶ AEMC, TFP Review: Draft Report, p 95

*these effects plus the effectiveness of the building block regime at that time should occur before a TFP methodology is implemented.*⁷

In contrast, the Commission's Preliminary Findings Paper raised a number of practical implementation issues, which led the Commission to conclude (amongst other things) that service providers should be able to choose to opt into a TFP methodology.

Further, SP AusNet's response to the Preliminary Findings Paper addressed the Commission's concerns in relation to gaming incentives where we noted:

*These concerns appear to ignore the fact that the building block regime already includes checks and balances to deter businesses from deliberately under-investing. In particular, the capital expenditure criteria in the Rules allow the regulator to assess whether the forecast expenditure reasonably reflects the efficient costs that would be incurred by a prudent operator. A finding by the regulator that the firm has engaged in inefficient investment deferral would be relevant to the regulator's assessment of the capital expenditure forecast. In addition, the on-going application of a service target performance incentive scheme would protect against the uneconomic deferral of capital expenditure under either of the two regulatory models.*⁸

It is therefore important for the Commission's Final Report to confirm the principle that service providers should be able to elect to return to building block regulation. Such an approach would be consistent with the NEO and NGO because it would ensure that service providers are capable of earning a reasonable rate of return.

For TFP-based regulation to be effectively provided as an alternative regulatory approach with an appropriate level of regard for regulatory certainty and the sovereignty of regulated businesses, the Final Report must address whether TFP-based regulation will be provided as a voluntary option for businesses and whether they would be locked into TFP once adopted.

2.4 Arrangements for the initiation of Stage 2

In the interests of promoting regulatory certainty and understanding the future work for this review, the Final Report should clarify aspects of how Stage 2 would commence and be progressed. Important issues include:

- Will the AER simply initiate Stage 2 by reporting to the Commission that the TFP conditions have been met?
- Is there an expectation that the Commission will commence a holistic review process to determine the most appropriate TFP methodology or will it be based on consulting upon a methodology put forward by the AER? If it is the latter, will the AER make recommendations to the Commission on an appropriate TFP methodology and put together a Rule Change to give effect to its preferred methodology as part of its recommendation to initiate Stage 2?

⁷ Ibid, p ii

⁸ SP AusNet, TFP Review: Preliminary Findings Paper Submission, February 2010, p 9

- Will the AER be expected to put forward recommendations in relation to the practical implementation of TFP-based regulation and a transition from building blocks?

Many of the practical implementation issues related to introducing TFP, such as the ability to opt-in to TFP regulation and the potential for businesses to face significant regulatory change require policy decisions to be made by policy makers and the Commission, rather than the regulator. Further there is the potential for significant regulatory uncertainty to arise from a lack of clarity around the future process and regulatory discretion in this Review.

It is therefore crucial that the Final Report address the above issues and clearly set out the process as to how Stage 2 will be conducted, including any potential rule changes to be effected in Stage 2.

3. Stage 2 TFP Review and Rule Change

SP AusNet has previously recommended that a detailed TFP design proposal be decided and articulated before any Rules providing for TFP-based regulation be introduced. This would address any regulatory uncertainty posed by an alternative regulatory approach as it would allow businesses to better understand how TFP may apply to them in the future.

A clearly codified TFP design which provides businesses with regulatory certainty is crucial to provide a successful transition to TFP regulation. The recommended approach set out above where the industry working group has participated in developing data specifications, TFP design/methodologies, and testing for necessary TFP conditions, would facilitate a level of agreement on a TFP approach. This is more likely to lead to support for an appropriate and detailed TFP approach to be codified and enshrined into the Rules. Under this approach, the Rules can balance the conflicting objectives of:

- providing sufficient flexibility on detailed regulatory arrangements (including off-ramps, transitional issues; and S-factor arrangements) to ensure that company-specific and jurisdictional issues are addressed appropriately; whilst
- providing DNSPs with sufficient regulatory certainty regarding the AER's application of the TFP approach, so that DNSPs can invest confidently in their networks.

Regulatory principles and TFP design

The more detailed TFP design features and issues that will need to be debated and consulted upon in Stage 2 of this review include:

- the principles, procedure and mechanics (specification of TFP growth rate, inputs and outputs, weightings, definitions) of the TFP approach. This would provide an appropriate degree of regulatory certainty and provide clarity for the market on the regulatory framework;
- the use of AER guidelines to provide clarity on technical matters for which there will be regulatory discretion and aspects of the approach which could be adapted to the individual circumstances of a business. Such guidelines should be binding, similar to those published by the AER under Chapter 6A and 6 of the NER for electricity transmission revenue resets and in distribution price resets;

- the application of the TFP methodology used throughout a regulatory period once a regulatory determination is made under that methodology; and
- continued use of the current established and well understood regulatory processes and instruments;
- the flexibility for businesses to propose the length of regulatory period;
- the use and design of mechanisms to be adapted for individual businesses including: cost pass throughs, off ramps and capital modules; and
- the ability to choose a fixed or rolling X-factor
- implementation issues such as how business might transition to TFP-based regulation and the timing of initial TFP price determinations

Codification of the above matters would assist in providing a clear and comprehensive TFP approach.

4. Conclusion

SP AusNet understands the reasons behind the Commission's draft decision to introduce rules to commence the collection of TFP data from distributors to allow for the future application of TFP should necessary conditions be met.

In Stage 1 of this Review data specifications should be developed in close consultation with industry so as to ensure the data is meaningful and useful. The means by which the data is collected should be streamlined with existing regulatory instruments such as the RIIIO, RINs and regulatory accounts as much as possible to minimise additional costs and maximise efficiency. Given that the Commission has found it unlikely that TFP would be appropriate for transmission, it is recommended the AER develop information specifications for distribution before transmission. Clarity around fundamental design and implementation issues such as the ability to opt-in to TFP-based regulation is necessary to address potential regulatory uncertainty in relation to the Commission's proposal.

Given the success of TFP-based regulation will depend on its design, it is crucial that the specification of a TFP design in Stage 2 be comprehensive and informed by the outcomes of this review. Clarity around how Stage 2 will be initiated and undertaken would enhance regulatory certainty in relation to the Commission's proposal.