23 December 2010

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

Email: submissions@aemc.gov.au

Dear Mr. Pierce

RE: TOTAL FACTOR PRODUCTIVITY REVIEW – FRAMEWORK AND DRAFT REPORT: EMO0006

1. Introduction

ETSA Utilities, CitiPower and Powercor Australia (**the Businesses**) welcome the opportunity to comment on the Australian Energy Market Commission's (**AEMC**) Draft Report - *Review into the use of Total Factor Productivity (TFP) for the Determination of Prices and Revenues* (**Draft Report**) published on 12 November 2010.

The Businesses agree with the AEMC that immediately introducing Total Factor Productivity (**TFP**) as an alternative to the Building Block approach would not satisfy the *National Electricity Objective* (**NEO**) at this time.

The Businesses do not contest the proposed two-staged approach to evaluating TFP. This position is, however subject to the AEMC adopting the Businesses' proposed changes to the two-staged approach as detailed in this submission.

The Businesses note that the Energy Networks Association (**ENA**), on behalf of its members, is making a detailed submission to the AEMC on its Draft Report. The Businesses have reviewed and fully endorse the positions set out in the ENA's submission.

2. Executive Summary

The Businesses agree with the AEMC that immediately introducing TFP as an alternative to the Building Block approach would not satisfy the NEO at this time.

The Businesses do not contest the proposed two-staged approach to evaluating TFP proposed by the AEMC, however they:

- Do not agree with the AEMC's assessment of the efficiency benefits of TFP compared to the Building Block because it is based on:
    - Lack of evidence of the failings and inefficiencies of the Building Block approach;
    - Purely theoretical analysis and ideological positions rather than real examples and evidence.

  These shortcomings mean that the AEMC's conclusions about the efficiency benefits of TFP are misguided, and are not consistent with good regulatory practice.
- Only agree with the two-staged approach if:
    - Some elements of each of the two stages are either locked in, or are locked out, now and cannot be revisited or changed later.

      Elements which should be locked in now include:
        - Continued availability of the Building Block approach under the National Electricity Rules (**Rules**);
        - Sole discretion for a distribution Network Service Provider (**DNSP**) to adopt TFP, and to revert back to the Building Block approach;
        - The ability for a DNSP to propose the length of the regulatory control period being greater than five years;
        - Provisions to normalise the data used to calculate the X factor; and
        - Provision of safeguards, such as pass-throughs and off-ramps, to address risks associated with the recovery of efficient and prudent expenditure.

      Elements which should be locked out now include:
        - P_0 determined based on actual historical data from the current regulatory control period only; and
        - The use of data from overseas DNSPs to calculate any future TFP index.

The proposed Stage One

The Businesses consider that the AEMC's proposed Stage One, which relates to data collection and testing, should be amended to include the following changes:

- In relation to the proposed annual TFP data collection;
    - An industry group should be established to assist the Australian Energy Regulator (**AER**) develop an appropriate Annual TFP Information Disclosure Statement;
    - Annual TFP data collection should co-exist in an efficient way with the AER's existing information requests. The AER should provide DNSPs with appropriate time to introduce new, or modify their existing, information collection systems which will enable them to collect the required information. DNSPs should be able to fully recover the additional cost of complying with new additional requirements, including

system replacement or upgrade costs, through a nominated pass through provision; and

- The identity of individual DNSPs should remain anonymous for the purposes of reporting annual TFP data, at least until such time as it is agreed that the data reported for each individual DNSP is robust and meaningful. The Businesses propose that the identity of individual DNSPs should remain anonymous and that DNSP specific data is labelled generically such as: DNSP One; DNSP Two and so forth.

- In relation to the first pre-condition that must be satisfied before progressing to Stage Two, being that '*available data is robust and consistent and can produce a TFP growth rate*' the AER should not be able to back-cast information in order to establish the data base required to satisfy this pre-condition; and
- The AER's discretion should be limited to the greatest extent possible. This is because the discretion that the AEMC proposes affording to the AER under Stage One is fundamentally inconsistent with the AER's mandate of being the rule enforcer, and not the rule maker.

The proposed Stage Two

The Businesses consider that Stage Two should involve the AEMC making a new rule to detail how TFP will be specified in the future. The new rules should address:

- The specification of outputs, inputs, time periods, weighting methods and the growth rate calculation method;
- The approach to data normalisation;
- Identification of industry subgroups; and
- The method for establishing a P_0 adjustment during a regulatory reset.

Stage two should only commence once the pre-conditions for TFP are fully satisfied.

Consultation

There should be a clear and transparent process built into the process for developing Stage Two for consulting with industry about how the rules will determine how TFP will be introduced and applied.

3. Structure of this submission

The remainder of this submission is structured as follows:

- Section 4 sets out why the Businesses do not agree with the AEMC's assessment of the efficiency benefits of TFP compared to the Building Block approach;
- Section 5 sets out elements of the proposed two-staged TFP approach that the Businesses consider should be either locked in now or locked out now;
- Section 6 describes changes that the Businesses consider are necessary to the proposed Stage One;
- Section 7 describes the changes that the Businesses consider are necessary to the proposed Stage Two; and

- Section 8 outlines the need for industry consultation about how the rules for how TFP will be introduced and applied.

4. AEMC's rationale for proceeding with implementing TFP

The Businesses do not agree with the AEMC's rationale, as set out in chapter 3 of its Draft Report, for proceeding with the implementation of TFP.

The AEMC's key rationale is that, when assessed against a range of criteria[1], TFP provides better incentive properties than the Building Block approach. The AEMC's rationale is based on:

- Unqualified criticisms about the Building Block approach. The AEMC has not sought to substantiate or support with examples its criticisms of the Building Block approach. In particular, the AEMC has not provided examples to support its allegations of DNSPs gaming the Building Block approach, which appears to be its principle (and only) criticism of Building Block approach.

  The Businesses note that there is considerable evidence to support that the Building Block approach effectively promotes the NEO. The Building Block approach is a well founded and accepted regulatory approach with extensive precedent in Australia for setting efficient revenues and prices.

  Moreover, the Businesses are concerned that the AEMC is considering introducing TFP, as an alternative to the building block approach, so soon after the new provisions of Chapter 6 of the Rules have commenced operation. The Businesses preferred position is that a review of Chapter 6 of the Rules should only occur after the new provisions of Chapter 6 have been fully tested - including in all jurisdictions. This would provide the industry and regulators with an opportunity to understand and work through the practical operation of the Rules and understand how TFP may work under the new framework;

- Purely theoretical analysis, underpinned by Economic Insights report entitled *A Model of Building Blocks and Total Factor Productivity–based Regulatory Approaches and Outcomes* (**Economic Insights Report**) about the benefits of TFP. Importantly, this analysis has been developed in the absence of:

  - A reliable, robust and comprehensive data-set being available, which is required to calculate a TFP index. The AEMC recognises that '*the existing data are not consistent, reliable nor robust*'[2]. Accordingly, the results from the Economic Insights Report cannot be relied on. The Economic Insights report itself recognises this as it states '*the regulatory data currently available are not fit for the purpose of robust TFP analysis of the standard required to base regulatory pricing and revenue determinations on*';

  - Any assessment of the practical application of TFP to regulated electricity or gas distribution businesses in Australia. TFP has never been applied to regulate electricity and gas distribution or transmission businesses in Australia, other than in the Northern Territory where a TFP '*like*' approach is applied to regulate Power and Water Corporation's distribution services.

[1] The criteria include: cost incentives; investment incentives; good regulatory practice; cost of regulation; and transition and implementation;
[2] AEMC Draft Report, page 61

It is understood that Power and Water was significantly under-funded in terms of its capital and operating expenditure allowance over the last regulatory control period (2004 to 2009)[3] potentially undermining the sustainability of its services to its customers; and

- The design framework for TFP being finalised. This relates to the specification of matters such as outputs, inputs, time periods, weighting methods and the growth rate calculation method. The AEMC has acknowledged that the specification of the design framework will impact on the resulting TFP growth rate.

The Businesses consider that these shortcomings mean that the AEMC's conclusions about the benefits of TFP compared to the Building Block are misguided and are not consistent with good regulatory practice. It is not clear how it is possible to undertake an accurate or meaningful assessment of the benefits of the TFP approach without the information identified above. This reflects the fact that there are many options available for the design framework for TFP, which can impact the ability of DNSPs to recover their efficient costs.

Further, the AEMC does not appear to have adequately taken into account:

- The findings of earlier and more recent studies by the Office of the Gas and Electricity Markets (**OFGEM**), which led to it not pursuing a TFP form of regulation. OFGEM has undertaken numerous studies of the potential benefits of applying TFP form of regulation. All of these studies, including its most recent studies entitled '*RPI-X@20 Emerging Thinking Consultation Document-Alternative Ex ante and Ex post Regulatory Frameworks*', dated 20 January 2010 and '*Regulating Energy Networks for the Future: RPI-X@20 Recommendations, Impact Assessment*', dated July 2010 have concluded that there is not a good case to move to TFP on the basis that TFP may result in high risks that:
  - Network companies could under-deliver in terms of service; and
  - Network companies' allowed revenues could be insufficient to meet their costs and provide fair returns to investors

  OFGEM further concluded that the development of a sustainable energy market means that the future requirements on network businesses are likely to be different to those that they have previously faced and therefore TFP would not provide an appropriate form of regulation.
- The difficulties faced by Dutch regulator Dienst uitvoering en Toezicht energie (**DTe**) and the Dutch regulated distribution businesses in relation to the setting of the X using a TFP like methodology (data envelope analysis). The Dutch network businesses appealed DTe's decisions, which carried on for several years as considerable cost to the distribution businesses and the regulator.

In summary, the Businesses do not believe the AEMC has presented a compelling case for the implementation of TFP nor has it conducted a balanced assessment of the risks it presents to the sustainability of the current service levels and network

[3] Power and Water Corporation, Initial Regulatory Proposal, 1 July 2009 to 30 June 2014, August 2008, page 17. Power and Water's Initial Regulatory Proposals states that application of the TFP like methodology resulted in it failing to recover over $60 million in operating and $80 million in capital expenditure in the first four year of the 2004 to 2006 regulatory control period.

performance. As has been noted in previous submissions by the Businesses, the practical case remains to be made why TFP is superior to the Building Blocks approach. That case needs to be based on real examples and evidence as opposed to ideology and hypothetical examples which have dominated the debate to date.

Notwithstanding the above, the two-staged approach to implementing TFP should be amended from that outlined in the Draft Report so that:

- Stage One would involve annual data collection, publication and calculation of an annual TFP index by the AER. This stage would also involve an annual assessment by the AER of whether the pre-conditions for TFP have been satisfied; and
- Stage Two would involve appropriate consultation, through the AEMC, of all of the matters related to the design, nature and implementation of TFP. This includes specification of outputs, inputs, time periods, weighting methods and the growth rate calculation method. It also involves appropriate consultation on the approach to data normalisation, identification of industry sub-groups and the approach to determining P_0 reset.

The nature of these two stages is discussed further in sections 6 and 7 below.

5. Elements which should be locked in or locked out now and not changed later

The AEMC's proposed two-staged approach for introducing TFP should be amended such that:

- Some elements of each of the two stages are locked in now and cannot be changed later; and
- Other elements of each of the two stages are locked out now and cannot be introduced later.

The Businesses consider that the following elements of the approach should be locked in now and should not be capable of being revisited or changed later:

- Continued availability of the Building Block approach under Chapter 6 of the National Electricity Rules (**Rules**), at the discretion of the DNSP, as a method to develop prices and revenues for a regulatory control period.

  This is important to the Businesses because their investors have made long term investment decisions based on a well understood and mature regulatory framework, namely the Building Block approach. This investment could be placed at risk if any amendment to the Rules provides for the mandated use of TFP to determine a DNSPs prices and revenues for the regulatory control period.

  TFP fundamentally changes the basis on which a DNSP's prices and revenues are determined and could create a disconnect between its costs and revenues. Accordingly, it is critical that the Building Block approach remains available to DNSPs as a means of regulating their prices and revenues. The AEMC should not be proposing economic experiments with the long term sustainability of the network or investors capital;

  The Businesses recognise, however, that over the next decade incremental refinements are likely to be made to the application of the Building Block

approach. The Businesses accept the prospect of these changes provided that there is appropriate consultation to ensure that any changes reflect the NEO. In particular, the Businesses encourage further review of recent changes implemented by OFGEM under its new regulatory framework known as the Revenue *equals* Incentives *plus* Innovation *plus* Outputs (**RIIO**) model;

- The option for a DNSP to adopt TFP, and to revert back to the Building Block approach, is at its sole discretion. This is important because if a DNSP is not recovering its efficient costs under the TFP approach, then it should have full discretion to revert back to the use of the Building Block approach between regulatory control periods, by giving notice to the AER two years before the start of a new regulatory control period. This could be clarified in the AER's '*Framework and Approach*' document which is a requirement of the Rules;

  This approach is necessary to ensure consistency with section 7A(2) of the National Electricity Law (**NEL**), which provides that a DNSP should be provided with a '*reasonable opportunity to recover at least the efficient costs the operator incurs in providing direct control network services…*'.

- DNSPs retain discretion under the TFP approach to propose the length of the regulatory control period being greater than five years. This is consistent with the current provisions under Chapter 6 of the Rules for the Building Block approach. A key advantage of the TFP approach is the potential for longer regulatory control periods as this would lower the costs of the regulatory review process. Accordingly, the Businesses consider that under the TFP approach a DNSP should have the option of having its revenues or prices reset at periods greater than every five years;

- The data used to calculate the X factor is normalised in order to account for the differences between DNSPs[4]. Normalisation is required to ensure that differences are adequately taken into account in order to allow a "like-for-like" comparison between DNSPs; and

- Appropriate safe-guards, such as pass-throughs and off-ramps, are provided to DNSPs under the TFP approach to address risks, including that the DNSP is not able to recover revenue required to fund its efficient and prudent costs during the regulatory control period. This may result from unexpected step changes in expenditure or the allowed revenue, under TFP approach, being insufficient to meet a DNSP's efficient costs that are required to enable it to earn an adequate return.

In addition, the Businesses consider that the following elements of any TFP framework should be locked out now and should not be able to be introduced later:

- P_0 determined based on actual historical data from the current regulatory control period only. This would be unacceptable for the reasons discussed in detail in section 7 of this submission; and

- The use of data from overseas DNSPs to calculate any future TFP index. This would be unacceptable because it is not possible to normalise the differences between overseas and Australian DNSPs, including on account of differences in

[4] Differences may relate to DNSPs service classification, operating environments, jurisdictional regulatory obligations, corporate objectives and ownership arrangements as well as technological and scale and scope differences

accounting policies, tax laws and corporate structures. Accordingly, only Australian DNSPs should be included in any future 'industry' TFP index.

6. Stage One - Data collection and limitation of the AER's discretion

The Businesses generally support the nature of the AEMC's proposed Stage One, which relates to data collection and testing only, provided that:

- The AER's discretion is limited to the greatest extent possible;
- The AER has regard to various matters associated with additional data collection; and
- The nature of the conditions necessary to move to Stage Two incorporate certain amendments.

6.1. The Businesses understanding of Stage-One

The Draft Report proposes that the AER will be charged with annually collecting certain data for TFP purposes – this has been referred to in this submission as the Annual TFP Information Disclosure Statement. The AEMC's Draft Report further proposes that:

- Data should relate to the DNSPs' key outputs and inputs and be historic rather than forecast;
- An industry working group should be established to assist the AER identify which outputs and inputs should be included in the Annual TFP Information Disclosure Statement;
- The AER should be required to develop a supporting Guideline to assist the information disclosure process;
- Completed Annual TFP Information Disclosure Statements should be published on the AER's website, albeit that DNSPs identities should remain anonymous at least until the industry is confident that the data reported by individual DNSPs is meaningful and robust;
- The AER should produce an annual TFP report only, which:
    - Includes a calculation of TFP data index based on information provided under annual TFP information disclosure;
    - Tests for the appropriate specification for calculating TFP; and
    - Identifies the appropriate definition of industry groups.
- The AER should assess annually whether the pre-conditions for TFP have been satisfied and publish its findings in its annual TFP report.

6.2. Matters associated with additional data collection

The Businesses support the AEMC's proposed Stage One subject to a range of data collection issues being clarified and locked in. In particular, the Businesses consider that:

- Consistent with the AEMC's Draft Report, an industry group should be established to assist the AER to develop an appropriate Annual TFP Information Disclosure Statement. The Businesses would welcome the opportunity to be a member of this industry group;
- Future data collection requirements must co-exist in an efficient way with the AER's existing information requests, albeit that the information requested for the purposes of TFP should be clearly identified.

  The Businesses do not support the proposal that the Annual TFP Information Disclosure Statement be issued separately, and in addition to, the AER's existing Regulatory Information Notice (**RIN**) and Regulatory Information Order (**RIO**). This would result in a considerable expansion and potential duplication of reporting requirements and will therefore result in greater costs because:

  - It is likely to require augmentation of the Businesses' existing reporting systems and additional resourcing; and
  - The requirement for a Director's sign-out will result in greater due diligence in collecting and reporting of information, including periodic audits to ensure the required confidence in the integrity of the data.

  Instead, the Businesses consider that all of the AER's data collection requirements, including for TFP, should be coordinated in a single consolidated instrument.

  In the event that it is decided that TFP data collection arrangements should remain separate and additional to existing data collection requirements, then the Businesses consider that they should be fully funded for the additional cost of complying with these new additional requirements; and
- The inputs and outputs identified in the Annual TFP Information Disclosure Statement must be reflective of all DNSPs' operations. The differences between DNSPs means that it would be extremely difficult for the AER to identify inputs and outputs that are relevant to all DNSPs in the absence industry involvement. The Businesses emphasise that it would be inappropriate for the AER to impose productivity measures that:
  - Are only reflective of the outputs of some DNSPs; and
  - Are not real inputs or outputs, including their relative weightings. The use of approximations for TFP input and output components should not be utilised in the name of efficiency.

6.3. AER discretion under Stage One

The Businesses consider that the discretion that the AEMC proposes affording to the AER under Stage One is fundamentally inconsistent with the AER's mandate of being the rule enforcer, and not the rule maker, and should therefore be limited to the greatest extent possible. In particular, the AER's discretion in respect of the following elements should be constrained:

- Adjustment of data reported in the Annual TFP Information Disclosure Statements. The AER's ability to adjust TFP data provided by network

businesses should be: limited; transparent; and consistently applied through a clearly defined process;

- Lack of transparency in the use by the AER of TFP data under the Building Block form of regulation. The Rules should require the AER to fully disclose whether and how they have used the TFP index under the Building Block approach and require the AER to provide the relevant DNSPs with their TFP models, assumptions and data-sets;
- Identification and recommendation of industry sub-groups to which an X factor will apply. This should not be undertaken by the AER as part of Stage One, but rather should be decided by the industry working group as part of Stage Two;
- Specification of TFP approach. This should be decided in consultation with the industry working group as part of Stage Two;
- Assessment of whether conditions necessary to support the implementation of TFP are satisfied. Currently, there is no proposed guidance or information provided on how the AER will make its annual assessment. This means that the AER has absolute discretion as to how it assesses whether each of the following have been satisfied:
    - The available data is robust and consistent and can produce a TFP growth rate consistent with the criteria specified for the TFP index calculation;
    - The TFP index growth is likely to be a reasonable estimate of future potential productivity growth of the industry group; and
    - Service providers within an industry group face comparable productivity prospects.

  In the absence of a defined approach to assessing whether, on the basis of the annual TFP data collected, these criteria have been satisfied, the AER can make its assessment without appropriate transparency and accountability. This is not consistent with good regulatory practice and the Businesses consider that a specific framework should be developed that constrains and guides the AER's annual assessment of these criteria.

6.4. Changes to the nature of conditions necessary to move to Stage Two

The Businesses consider that in relation to the first pre-condition, set out above, that must be satisfied before progressing to Stage Two, the AER should not be able to back-cast information in order to establish the data base required to ensure that '*available data is robust and consistent and can produce a TFP growth rate*'.

The data set used to inform the TFP index should be based on fresh data collected annually from DNSPs as part of the process under Stage One, and no back-casting or 'cleaning' of historical data should be permitted.

This is because, as acknowledged in the AEMC's draft report, there are various factors that prevent the development of a meaningful data set of comparable historical expenditure on the basis of current data. These differences may relate to, amongst other things, their service classification, operating environments, jurisdictional regulatory obligations, corporate objectives and ownership arrangements as well as technological and scale and scope differences.

7. Greater specification is provided around Stage Two

The Businesses consider greater specification is required up-front in relation to the nature of Stage Two. In particular, the Businesses consider that some matters should be considered in Stage Two rather than Stage One.

The Businesses consider that the following matters should be addressed in Stage Two:

- Specification of outputs, inputs, time periods, weighting methods and the growth rate calculation method. The Businesses note that while the AEMC has commissioned a number of reports on these matters, agreement has not been reached amongst industry. Further, changes to the industry that may occur during Stage One mean that it is not likely to be efficient or meaningful to determine these matters before commencing Stage Two. These matters should therefore be addressed in Stage Two, rather than Stage One;
- The approach to data normalisation. While the Businesses support normalisation of data, which is required in order to take account of difference and allow a "like-for-like" comparison between DNSPs, an agreed approach will need to be developed to ensure consistency and transparency of data normalisation. This should be addressed in Stage Two;
- Identification of industry subgroups. Using multiple industry subgroups recognises that the application of a single TFP index to all DNSPs may not be reasonable because there are significant factors that may cause variation in the rate of change of productivity for businesses within the industry. These include for example climate, topography, density or technology. Addressing this through subgroups will require detailed discussion and agreement of the basis on which DNSPs should be grouped together for the purposes of applying a TFP index. This is because businesses within the subgroup must be sufficiently similar and the sub-group must be of an appropriate sample size to ensure reliability. If an appropriate subgroup cannot be identified for a DNSP then it may be appropriate to develop a specific X factor for that DNSP. In any event, this should be addressed in Stage Two;
- The method for establishing a P_0 adjustment during a regulatory reset. Appendix C of the Draft Report sets out four alternative options to calculating the P_0 adjustment during a regulatory reset, and recommends Option One as the preferred approach. Option One involves setting starting prices based on outturn data from the last two years of the current regulatory control period and does not allow for consideration of forecast costs including any required step changes in expenditure. The Draft Report cites the following as the primary justification for its recommendation[5]:

  > '*By ensuring that the service provider covers its reasonable costs at the start of the regulatory period, it ensures services providers can recover their reasonable costs over the whole regulatory period provided they at least match the productivity growth of the industry group'*.

  The Draft Report further states[6]:

[5] AEMC TFP Draft Report, page 130
[6] AEMC TFP Draft Report, page 126

This approach has been described as the 'partial building blocks' approach in New Zealand

In relation to the first statement, the Businesses consider that this logic is flawed as it assumes that the historic costs, being those costs incurred in the last and penultimate years of the current regulatory period, are representative of the costs in the next regulatory control period when adjusted for TFP.

The Businesses do not support this approach because it assumes a 'steady state', whereby DNSPs are subject to little external change. In practice, there is no evidence to support that DNSP's have ever been, or are likely to ever be, in a 'steady state'. This is because there are a range of external factors that may impact on what DNSPs are required to deliver. In particular, this could be driven by:

- An ageing asset based which requires an increase in asset replacement or refurbishment expenditure;
- Legislative changes to, amongst other things, superannuation levels of defined benefit obligations, which can be materially affected by market performance;
- New regulatory obligations such as Victorian Bushfire Royal Commission recommendations that fundamental change the way a distributor operates;
- Technological changes such as Advanced Interval Metering, smart grid and growth in photo voltaic installations that change the underlying expenditure profile of a business;
- Unforseen growth in new connections, or growth in the volumes of some services; or
- The effect of transitioning to a lower emissions environment, which will impact on the type and nature of investment DNSPs make in the future, such as the roll-out of smart meters and smart networks.

This means that past productivity performance is not likely to be a reasonable or unbiased predictor of future productivity growth. This is supported by:

- Recent regulatory determinations for the New South Wales, Queensland, South Australia and Victorian DNSPs, in which the AER allowed for significant increases in expenditure between the current[7] and next[8] regulatory control periods; and
- The TFP-like approach taken in the Northern Territory. As noted, the application of this approach, whereby only outturn costs were considered in determining the P_0, has reportedly led to a significant divergence between allowed and actual costs such that the DNSP has apparently not been funded for efficient and prudent expenditure.

This raises significant concerns about whether TFP, if the P_0 is based on historic cost only, can ever provide a DNSP with a *'reasonable opportunity to recover*

[7] Current regulatory control period meaning either the 2005-10 or 2004-9 regulatory control period depending on the jurisdiction.
[8] Next regulatory control period meaning 2010-15 or 2011-16 regulatory control period depending on the jurisdiction.

at least the efficient costs' as is required by section 7A(2) of the National Electricity Law.

In relation to the second statement concerning New Zealand, the Businesses consider that this is incorrect and misleading.

The use of the Building Block approach is new to the New Zealand regulatory framework for DNSPs. The New Zealand regulatory framework is currently being reviewed to incorporate the concept of a full Building Block (involving forecast expenditure for each year of the regulatory control period) as an alternative form of regulation to the Default Price Path, which is based on a TFP like approach. These reforms are driven by the perceived need to provide greater certainty and transparency with respect to price and revenue regulation.

Under the Default Price Path, the framework for determining starting prices is currently being developed. In developing this framework, section 53P(3) of the *Commerce Act 1986* (Act), which governs resetting of starting prices at the commencement of the regulatory control period, requires that:

The starting prices must be …prices determined by the Commission that are based on the current and projected profitability of each supplier.

This means that the AEMC is required to develop an approach which considers future expenditure and which does not simply rely on outturn expenditure to determine starting price for the next regulatory control period.

As a result, the Businesses consider that a P_0 reset should include an assessment of forecast expenditure.

- The Businesses consider that the AEMC, rather than the AER should develop the detailed specification of Stage Two, once it has been determined that it will proceed. This is bec
- ause the AEMC is the rule maker and the AER is the rule enforcer. The nature of Stage Two is that it will effectively involve making a new rule to specify how TFP will be specified in the future – this can only legitimately be done by the AEMC. As per the consultation requirements relating to rule making, the Businesses expect that the future development of the TFP specification rule should be undertaken through a fully consultative process with industry.

8. Consultation with industry

There should be a clear and transparent process, built into Stage Two, for consulting with industry about how the rules, relating to the introduction and application of TFP, will be developed. The Businesses strongly believe that an industry working group should be established as the focal point of this consultation and that this group should consider all aspects of the introduction of TFP. The Businesses would welcome the opportunity to be represented on this working group.

9. Closing

Should you have any further questions in relation to this submission, please do not hesitate to contact Stephanie McDougall on (03) 9683 4518 or at smcdougall@powercor.com.au

Yours sincerely

[signed]

Richard Gross

General Manager Regulation