

Victoria's Views on TFP



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“Building Blocks” Approach - What is it?

- The current “Building Blocks” approach relies on submissions of forecasts of expenditure, demand and customer numbers for the relevant time period, by each network business.
- Based on an assessment of these forecasts, the regulator determines a sequence of price movements over the regulatory period, for each business.
- The regulator establishes a start price (“ P_0 ”) at the beginning of the regulatory period, then an “X” value for the “CPI-X” adjustment in each subsequent year of the regulatory period.

“Total Factor Productivity “ - What is it? (1)

- “Total Factor Productivity” is a potential alternative approach for regulating price movements for network services, but is not currently allowed for under the NER.
- Under TFP, the regulator would use an externally derived productivity indicator to establish the “X” value for each year.
- To derive this indicator, it is necessary to analyse available and appropriate historic industry-wide input and output data.

Total Factor Productivity - What is it? (2)

- The “X” value is the resulting calculation of *actual* average annual industry-wide performance (or efficiency).
- With this value having been established for the annual regulatory “CPI-X” price adjustment, any given network business that outperforms industry will keep the gains.
- The TFP approach better simulates the discipline of competitive markets, and is potentially a more efficient and effective alternative to the “Building Blocks” approach

Total Factor Productivity - Advantages

- Improves incentives for business efficiency as gains can be kept for a longer period.
- More certain basis for sharing gains with consumers.
- Incentive to “game” the regulatory process by businesses is reduced.
- Less onerous regulatory process re forecasting, information gathering, etc.
- More responsive to step changes in costs and operational environment as productivity indicator (“X”) can be updated on a regular (say, annual) basis.

Total Factor Productivity - Disadvantages/Issues

- Jurisdictions are at different stages re the availability of appropriate data.
- Can a sustainable starting point be achieved?
- Unfamiliarity and hence cautious attitude by businesses to transition to TFP.
- Can existing service incentives and other refinements be retained?
- How to manage impact of cost to a business of a one-off exogenous project?

Total Factor Productivity - Other Considerations (1)

- Significant work done by ESC to examine TFP option.
- Review of alternative approaches undertaken by “Expert Panel”.
- Businesses could be given option to adopt TFP (at least initially).
- Pre-conditions for endorsement of adoption need careful drafting.

Total Factor Productivity - Other Considerations (2)

- Not desirable for individual businesses to abandon TFP, once adopted.
- Actual TFP methodology likely to be less controversial than other matters to be settled.
- Need to find right balance between allowing for TFP to be managed through future AER “guidelines”, versus specifying key details, up front, in the Rules.