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Australian Energy Market Commission
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Dear Sir/Madam

Proposed Rule Change – Total Factor Productivity for Distribution Network Regulation

Ergon Energy Corporation Limited (Ergon Energy) is pleased to make this submission to the Australian Energy Market Commission (AEMC) in response to the Rule change proposal for Total Factor Productivity (TFP) for Distribution Network Regulation.

Ergon Energy does not support the introduction of TFP as an alternative control setting methodology in the National Electricity Rules at this time and believes that the proposed Rule Change is premature. Ergon Energy considers that there is a reasonable expectation that the issues identified by the Expert Panel on Energy Access Pricing regarding TFP would be subject to further review prior to TFP being adopted.

Ergon Energy submits that in the absence of these issues being consulted upon and fully addressed, the current Rule change proposal can not be comprehensively assessed against the National electricity objective.

Please do not hesitate to contact me or Carmel Price, Manager Regulatory Affairs Network Regulation on (07) 41219545 should you wish to discuss this submission in any way.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Tony Pfeiffer', written over a horizontal line.

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Ergon Energy Corporation Limited

**Total Factor Productivity Rule Change
– Submission**

**Australian Energy Market Commission
22 August 2008**

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1 Introduction

Ergon Energy Corporation Limited (Ergon Energy) welcomes the opportunity to provide comment to the Australian Energy Market Commission (AEMC) on the proposed *National Electricity Amendment (Total Factor Productivity for Distribution Network Regulation) Rule 2008*.

This submission is provided by Ergon Energy in its capacity as an electricity distribution network service provider in Queensland.

Ergon Energy would be pleased to discuss this submission with the AEMC and to provide further information should the AEMC require.

2 Approach

This submission is in two parts.

Section 3 outlines Ergon Energy's concerns with including Total Factor Productivity (TFP) as an alternative to the building block control setting method in the National Electricity Rules at this time given key threshold issues identified by the Expert Panel on Energy Access Pricing (Expert Panel) and acknowledged by the Ministerial Council of Energy (MCE) as requiring resolution prior to the introduction of TFP have not been addressed.

Section 4 outlines Ergon Energy's concerns with the TFP control setting method proposed by the Victorian Department of Primary Industries (DPI) in its draft Rule change proposal.

3 Inclusion of TFP in NER

Ergon Energy does not support the introduction of TFP as an alternative to the building block control setting method at this time.

Chapter 6 of the National Electricity Rules was recently developed under a fully consultative approach and has only just commenced operation. As part of the consultation on the new provisions of Chapter 6, TFP was considered in detail as a possible control setting method by the Expert Panel appointed by the MCE. It was determined that specific Rules allowing TFP to be used as an alternative to the building block methodology not be included at this time.

Expert Panel Findings

While the Expert Panel did find that the adoption of TFP-based price control setting method does have merit to bring about a significant reduction in the costs of regulation it placed significant qualifiers on its adoption. In particular:

- The task of deriving an estimate of industry wide TFP is controversial and it can't be expected that regulators and service providers will reach ready agreement on the precise approach and its outcome;
- The development of robust TFP estimates depends upon availability of long term, reliable information on outturn costs of supply as well as a range of physical input and output parameters. The Expert Panel noted that the quality

and robustness of regulatory accounting information in the Australian energy sector is poor and varies from one jurisdiction to another;

- Consideration of whether or not it was appropriate to differentiate the long-term TFP estimate to be applied, by reference to the environmental characteristics of different energy networks. The Expert Panel noted that addressing this issue is likely to be contentious and may be hampered by the absence of long-term robust data; and
- The development of the Rules to update price controls such as: the duration the control should be fixed; the triggers (if any) for updating either initial prices or X estimates; how initial prices will be adjusted to be brought into line with costs where a TFP price cap is reviewed; and how service incentive mechanisms will be incorporated into both the design of off-ramps and the P reset process.

The Expert Panel noted that much of the work that has been undertaken to date in Australia on the potential development of a TFP-based control setting method, is yet to address these issues in sufficient detail so as to allow a full consideration of the merits of moving forward with such a reform.¹

Similarly Ergon Energy submits that insufficient work has been undertaken on the development of a TFP-based control setting method to determine whether it is likely to contribute to the achievement of the national electricity objective, either generally or in respect of the particular Rule change proposal submitted by the DPI. In particular, there is limited information available regarding:

- Whether the TFP approach will allow a regulated network service provider a reasonable opportunity to recover at least its efficient costs²;
- The availability of data and the cost of data collection to support TFP control setting method;
- Whether the TFP approach will result in any efficiencies, in terms of regulatory oversight of DNSP businesses, particularly if there is a requirement to undertake periodic cost-based building block reviews.

The Expert Panel also placed what it considered perhaps the most important qualifiers on the adoption of a TFP control setting method being that:

- The businesses or industry being regulated are in a relatively steady state, i.e. a long term estimate of TFP represents a relatively good estimator of future cost and or demand changes; and
- It is adopted at times in an industry's or business's life cycle where its forward-looking capital expenditure has a relatively smooth profile.³

¹ Expert Panel on Energy Access Pricing, Report to the Ministerial Council on Energy, April 2006, pages 103 – 104.

² Section 7A, National Electricity Law.

³ Expert Panel on Energy Access Pricing, Report to the Ministerial Council on Energy, April 2006, pages 104 – 105.

Ergon Energy does not consider that the industry is currently in a relatively steady state. The National Electricity Market is continuing to undergo significant regulatory reform. Notably, Chapter 6 of the Rules has only just commenced operation and has introduced significant changes regarding how distribution services are regulated. (Refer section 4 on discussion of inconsistency of TFP with Rules' services classification requirements)

Ergon Energy also does not consider that the industry is at a point in its 'life cycle' where forward-looking capital expenditure has a relatively smooth profile. Ergon Energy is currently experiencing significant load growth in its area which requires substantial investment in its network infrastructure. Ergon Energy understands that high load growth is also factor on other distribution networks.

AEMC Review

Given the issues identified with the introduction of TFP as a control setting method, the Expert Panel recommended that the MCE direct the AEMC to undertake a review of TFP that addresses:

- The circumstances in which the application of a TFP-based price setting methodology would contribute to the NEL and NGL objectives;
- The data collection arrangements that need to be put in place to facilitate its application; and
- As appropriate, the development of draft Rules to support the application of a TFP-based form of control for any individual or group of electricity or gas distribution or transmission service providers.⁴

In its Response to the Expert Panel's recommendations, the MCE accepted that such a review of TFP should take place and noted that given this would be a significant development in the regulatory framework, the review would need to be thorough and adequately resourced. In its' response the MCE stated:

The MCE is aware that in consultations on the Expert Panel's terms of reference and its draft report, a number of submissions commented that further analysis of TFP was required. The MCE believes that its policy on TFP will be better informed after the AEMC has undertaken its detailed review and after the other elements of the economic regulation reform package become operational.⁵

Timing of Proposed Rule Change

Ergon Energy is strongly of the view that the timing of DPI's proposed Rule Change is premature. There is a reasonable expectation that the threshold issues identified by the Expert Panel, and acknowledged by the MCE, would be thoroughly reviewed, consulted upon and addressed prior to the introduction of any specific Rules allowing TFP as an alternative control setting mechanism.

⁴ Expert Panel on Energy Access Pricing, Report to the Ministerial Council on Energy, April 2006, pages 117.

⁵ Standing Committee of Officials of the Ministerial Council on Energy 2006 Comprehensive Legislative Package: Overview and Response to Expert Panel on Energy Access Pricing, November 2006, page 21.

Ergon Energy considers that in the absence of a detailed review, the current Rule change proposal can not be comprehensively assessed against the National Electricity Objective⁶.

Ergon Energy submits that any review should only occur after the new provisions of Chapter 6 of the Rules have been in operational for some time (this should be after each service provider has had one full cycle of applying Chapter 6). This would provide industry and regulators an opportunity to ‘work through’ the practical application of the new provisions and gain a better understanding of how a TFP control setting method would operate in this new framework.

4 Response to Rule Change Proposal

In addition to its broader concerns about the timing and lack of information supporting DPI’s draft Rule change proposal, Ergon Energy has concerns with the specific provisions of the proposed Rule. These are set out below:

Inconsistency with the Rules’ services classification requirements

Ergon Energy believes that TFP is likely to be impractical as a control setting method because Distribution Network Service Providers (DNSPs) will have different services included within their standard control services category. They will therefore also have different cost components. As a consequence, the information used in the calculation of both their “inputs” and “outputs” (i.e. productivity) for these services will not be comparable between DNSPs, and therefore not applicable to any DNSP under TFP.

Put differently, it would not be appropriate to apply TFP where DNSPs have different standard control services – this is very likely to be the case under Chapter 6 of the Rules, at least for the first full cycle of distribution determinations.

Calculation of the X-factor is unclear and increases revenue uncertainty

Ergon Energy considers that it is not clear from the draft Rule change proposal how the “pool” of DNSPs will be determined for the purposes of calculating TFP.

The draft Rule change proposal would require DNSPs to be in a steady state before they can be included in the pool. Ergon Energy considers that this is a highly theoretical concept that never actually exists in practice. All businesses are inherently dynamic in nature and need to constantly change in response to market and regulatory developments.

Ergon Energy is further concerned that there is a potential for DNSPs to be included in the “pool” even if they have not chosen to use TFP themselves, or have different combinations of services and services groupings that comprise the “standard control” classification.

The draft proposal also states that DNSPs will not be included in the pool if they are “expected to experience a lower or higher productivity growth than the industry average” (page 15). This seems to be impossible to predict and to contradict the stated objectives of TFP.

⁶ National Electricity Law section 7

Ergon Energy also believes that DPI's proposal to allow the use a rolling X mechanism, whereby X is calculated annually by the AER based on the previous years' total productivity data, increases DNSPs' revenue uncertainty. At the commencement of the regulatory control period, the DNSP only knows the X factor calculation for the first year and has no certainty in relation to the value of X for the remainder of the regulatory control period. The revenue uncertainty created under this approach is not consistent with how investment decisions are made by utilities, where forward certainty of funding levels is required.

Calculation of P⁰ and opening tariffs is uncertain

The Rule change proposal sets out alternative methodologies for calculating 'initial tariffs' depending on whether a building block or a TFP control setting method was adopted in the previous regulatory control period. In both cases, the AER is given broad discretionary powers to make adjustments and DNSPs are provided with limited certainty as to the operation of the Rules.

In respect of the calculation to apply where the building block control setting method was employed in the previous regulatory control period the AER is given broad discretionary power to make adjustments to the tariff in force in the last regulatory year of the control period to calculate the 'initial tariffs' for the next regulatory control period. For example, draft clause 6.6A.5(b)(4) provides:

The AER may make such adjustments to that tariff or tariffs as the AER considers are necessary in any case where there is a difference between the forecasts upon which the tariff or tariffs were based and the actual costs that the Distribution Network Service Provider has incurred for the building blocks regulatory period.

The clause also provides for further adjustments due to the application of an efficiency benefit sharing scheme and by reason of the fact that the building block approach is not to apply. The draft clause does not, however, provide any guidance on how these adjustments should be made, increasing the level uncertainty for DNSPs.

In respect of the calculation to apply where a TFP control setting method was applied in the previous regulatory control period the draft Rules require the AER to assess the actual operating and capital costs incurred by the DNSP and compare them with the revenue it received in the same period in order to assess whether the revenues were less than, met or exceeded the costs. The AER is then required to determine how much the tariff for the last regulatory year of the prior regulatory control period should be increased or decreased to equate costs with revenues (draft clause 6.6A.5(c)).

The draft Rules require the AER to use the building block approach to assess the DNSP's costs. It further states that a 'modified' Part C shall apply to undertake this assessment. Again the draft Rules provide no detail or certainty about what 'modifications' to Part C would be required, providing substantial discretion to the AER and increasing the level of uncertainty for DNSPs.

DNSP's rewarded and penalised on a relative rather than absolute efficiency basis

Ergon Energy believes that the discussion of TFP confuses absolute and relative “input” and “output” measures. TFP only deals with relative improvements in efficiency or productivity, not absolute improvements. This means that:

- DNSPs could be rewarded on the basis that they achieve “above average” productivity, and therefore performing relatively well, although they may not have made any absolute improvements in their own productivity; and
- DNSPs could be penalised on the basis that they achieve “below average” productivity, although they might have demonstrated absolute improvements.

Accordingly, Ergon Energy believes that there is no reason to believe that a DNSP would be allowed only to recover its absolute efficient costs under TFP.

Ergon Energy also notes that DPI appears to have given no consideration to the implications for customers of penalising DNSPs that are “below average”. In a practical sense, these DNSPs would be able to earn less revenue while needing to make up their notional performance “shortfall” in the future. TFP is therefore a regressive, not progressive, approach that may embed and widen the existing gap between the performance levels of DNSPs in the NEM.

Significant regulatory discretion provided to the AER

Ergon Energy is concerned about the extent of discretion that the AER would be given under the proposed TFP approach, including to determine:

- What information would be included, and how this information would be calculated, in the “inputs” and “outputs” used to calculate X;
- The nature of the relationship between P^O and X; and
- Other detailed implementation and technical issues associated with adopting TFP.

Ergon Energy notes that the Rule change proposal provides for the AER to issue Guidelines in relation to the TFP methodology and its application. While comprehensive Guidelines would provide some certainty for DNSPs (noting under the Rule change proposal that the guidelines would not be mandatory – draft clause 6.2.8A(c)) this approach gives significant discretion to the AER to develop key aspects of the control setting method. This could diminish the separation between “rule maker” and “rule enforcer”.

In comparison, the Rules are relatively prescriptive about key aspects of the building block control setting method which appropriately limits the discretion of the AER. Ergon Energy submits that this approach is to be preferred over the approach adopted in DPI's Rules change proposal.

Ergon Energy is also concerned that once a DNSP has chosen to use TFP it is then up to the AER to determine whether it can return to using a building block approach in future regulatory control periods (draft clause 6.2.4A(d)).

Increased information collection and reporting requirements for all DNSP's

Ergon Energy is concerned that, even if it does not choose to apply TFP for itself, it (and other DNSPs) may be required to collect, maintain and provide information to the AER to aid its application of, or inform its calculation of, TFP for DNSPs which choose to be regulated under this approach. Ergon Energy believes that these information requirements would:

- Impose an unnecessary administrative burden on Ergon Energy (and other DNSPs). The impact of this draft Rule change proposal could therefore not be limited to DNSPs that may choose to apply TFP as the control setting method. Ergon Energy notes that only DNSPs that think that they can financially benefit from moving to TFP will choose to do so; and
- Greatly incentivise DNSPs to game the presentation of the information used in the calculation of both their “inputs” and “outputs”. This is because TFP relies very heavily on DNSPs to guide the “inputs” and “output” information needed to calculate the rolling X factor.