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By e-mail: submissions@aemc.gov.au

Dr John Tamblyn
Chairman
Australian Energy Market Commission
Level 5, 201 Elizabeth Street
Sydney NSW 2000

Dear Dr Tamblyn

Total Factor Productivity Rule Change Proposal

Jemena Electricity Networks (Vic) Ltd (Jemena) (formerly Alinta AE Ltd) has reviewed the Total Factor Productivity Rule Change Proposal (the TFP Proposal) submitted by the Victorian Department of Primary Industries.

Jemena supports evolutionary change in regulatory principles and practice. This includes consideration and development of alternatives to the current building block method of determining regulated revenues and prices. Total Factor Productivity (TFP) regulation is one such alternative that warrants serious consideration. However, the TFP Proposal represents a particular point of view of TFP regulation and how it should be implemented. It effectively supplants the wider review recommended by the Expert Panel which reported on Energy Access Pricing in April 2006.[1]

In Jemena's view, the rule change process is too restrictive a framework in which to consult on such a fundamental change to the principles of economic regulation because the consultation is effectively constrained to the proposal at hand. To date there has been no meaningful industry-wide consultation in Australia on TFP or other alternatives to building blocks. That consultation should take place before specific rule changes are considered. A wide-ranging review of the type proposed by the Expert Panel should be undertaken as a first step to examine TFP and possibly other alternative forms of regulation. Draft rule changes could then be developed out of that review.

[1] The Expert Panel on Energy Access Pricing recommended that the MCE direct the AEMC to undertake a review "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." (Expert Panel Final Report, p117)

The TFP Proposal also comes at a time when the gas and electricity industries have just been through a protracted period of consultation on Law and Rule changes and where other important consultations on WACC parameters and the National Energy Customer Framework are ongoing. In addition, NSW and ACT electricity distribution price reviews are in progress so TFP cannot be an option for those businesses, and it must be doubtful whether a TFP regime could be established in time for it to be an option in the forthcoming Victorian reviews. There is no apparent cause for haste at this stage.

Development and implementation of any alternative form or regulation will involve considerable cost and effort in consultation on rule changes and in establishing guidelines and other associated administrative arrangements. In order to justify that cost and effort there should be a reasonable expectation at the outset that:

- the benefits predicted for the option are real and attainable and
- the option, once available, will be taken up by a reasonable number of eligible businesses.

  In the end, a business's decision on whether to opt for any alternative form of regulation will depend on the detail of the alternative once it is fully codified, and an analysis of its implications for the business. There are aspects of the TFP Proposal, such as the proposal to undertake a building block re-set to costs at each price review, that can be expected to inhibit uptake.

In Jemena's view, rule changes developed out of a wider-ranging initial review are more likely to satisfy these criteria.

Comments on the TFP Proposal

Jemena has a number of high-level observations to make on the TFP Proposal itself. Assuming that the Commission will continue to consider the TFP Proposal under the rule change process, we anticipate making submissions at a more detailed level at later stages in the consultation.

- A threshold issue for Jemena and, we understand, for other distribution businesses, is that it must be for a business (and the business alone) to initiate the transition from building block to TFP regulation – there must be no avenue for TFP regulation to be imposed on a business without its consent. It is pleasing to note that the TFP Proposal provides for that election.

- There are presumptions about process and structure in the TFP Proposal that have not been tested, such as:
  - the extent to which important matters of detail should be left to non-binding guidelines to be developed by the AER;
  - the various discretions that will be conferred on the AER in applying TFP; and
  - having the decision on eligibility to move to TFP made as part of the price review process.

  The rule-change process is not necessarily the best framework in which to test these presumptions.

- By including a P_0 adjustment where revenues/prices are reset to "efficient costs" at each review, the TFP Proposal is perpetuating the very problem that besets the building block method as it has been applied. That is that nobody, including the regulator, knows what the efficient costs are for a business. Incentive regulation was intended to overcome this problem by inducing businesses to reveal their efficient costs by responding to incentives. In its purest form, this remains an attractive concept. In practice, under building blocks, regulators have set price paths based on their assessments of efficient costs. The resultant "incentive" is a stick rather than a carrot. Consumers are handed the benefits of anticipated efficiency gains irrespective of whether they are attainable and the service provider does not share in those benefits.

It is noteworthy that errors in P_0 go directly to the present value of the business's revenue stream for the entire regulatory period whereas errors in the rate of change of prices (X) have a less direct, but still potentially significant, effect. At a superficial level, the TFP Proposal involves little more than replacing one method of determining X which is acknowledged to be error-prone, with another that is equally susceptible to error.

- It is Jemena's understanding that WACC and depreciation will continue to be key inputs to the assessment of the P_0 adjustment at the time of reviews as well as for the ongoing calculation of TFP and performance monitoring. The TFP Proposal is silent on the question of WACC. In fact under the draft rule change a service provider would not be required to make a submission on WACC as part of its pricing proposal (see proposed Schedule 6.1A (b) which omits reference to clause S6.1.3(9)). On depreciation the TFP Proposal stipulates that "for the purposes of applying clause S6.1.3(12), depreciation is to be calculated on the basis of the actual depreciation of the assets concerned." (see proposed Schedule 6.1A (c)) "actual depreciation" is not defined.

  Issues around the setting of WACC are a significant contributor to the cost of building block regulation. While the scope for debate is likely to be reduced once the AER has completed its review of WACC parameters, WACC will continue to be an important input for TFP regulation.

- One of the benefits claimed for TFP regulation is that it obviates the need for forecasting which is a significant contributor to the cost of administering building block regulation. There are at least two instances in the proposed scheme where there is an implicit requirement for forecasting e.g in the criteria for deciding whether a business is eligible to choose TFP regulation (see proposed clauses 6.2.4A (b)(2) and (3)) and in applying the "TFP Criterion" (see proposed clause 6.6A.3).

  It is difficult to see how the revenue and pricing principles in section 7A of the NEL and s7A(2) in particular, can be satisfied without regard to forecasts.

  The eligibility test in proposed clauses 6.2.4A (b)(2) and (3) also highlights the tension that exists between the TFP methodology, where revenues/prices and costs are de-linked, and s7A(2) of the NEL. The test effectively places the AER in the odd position of ensuring that the service provider is prevented from making what might be a bad business decision (or from enjoying gains that might be considered excessive). This intention is confirmed at page 39 of the TFP Proposal:

  > There are a number of measures in the Rule proposal that, in combination, should ensure that [s7A(2) of the NEL is satisfied], including:
  >
  > … to 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;

- The TFP Proposal does not identify decisions that should be reviewable. There are a number of decisions in the proposed scheme that are likely to have significant consequences for businesses and that should be reviewable. These include decisions to:

  - withhold consent for a business to move from building blocks to TFP or from TFP to building blocks;

- add (or continue to include) data for particular businesses in the X factor data pool;
- vary the form of the TFP model i.e. to vary the specification of input and output measures and/or their weightings; and
- disallow pass through of a cost.

Should you wish to discuss this submission please contact Warwick Tudehope on (02) 9270 4551.

Yours sincerely

Alf Rapisarda
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