



Improving network regulation

Review into use of Total Factor Productivity (TFP): Final report

Network costs contribute significantly (40 to 60%) to residential electricity and gas bills. In this review, the AEMC found that using a TFP-based methodology could contribute to improvements in electricity and gas network regulation to achieve more efficient outcomes for consumers. Before the implementation of TFP-based network regulation could be considered, more consistent and robust data on network business' inputs and outputs needs to be collected and reported to the regulator. This data will improve the application of the current regulatory framework.

What is TFP and why apply it?

The current application of the 'building blocks' approach to network regulation relies on information specific to each network business. Under a TFP-based regulatory approach, the productivity growth rate for a group of businesses is used to determine the rate of change of regulated revenue or prices for all network businesses. In this way, TFP-based regulation can expose the monopoly businesses to pressures similar to competitive market conditions.

The AEMC has found that using TFP-based regulatory methods, either to support the current building blocks approach or as an alternative regulatory approach:

- would create stronger performance incentives for regulated network businesses;
- could improve demand management because it encourages better asset utilisation;
- could decrease regulatory costs including litigation costs.

These efficiency benefits would lower prices for consumers in the long term, while giving network businesses a reasonable opportunity to recover prudent costs and maintaining incentives to invest.

Conditions for implementing TFP

Before TFP-based regulation could be implemented, consistent and robust data on network businesses' inputs and outputs is needed. Once collected, the MCE would then need to assess if the conditions required for introducing a TFP-based methodology are met. The MCE would also need to consider the merits of offering it as an alternative to the building blocks approach at that time. For these reasons, the AEMC is at this stage proposing initial rules which will facilitate data collection and the assessment of whether the necessary conditions for introducing TFP are met.

The proposed data collection will have broader benefits of improving current regulatory practice, transparency and achieving the efficiency potential of incentive regulation by facilitating greater use of benchmarking and assisting the regulator to address information limitations. This will, in turn, provide both network businesses and consumers with greater confidence that prices reflect efficient costs over the long term.

Collecting reliable and useful data will increase confidence in the framework's ability to ensure that gas and electricity prices reflect efficient costs over the long term.

The AEMC's analysis in this Review will help inform stakeholders' understanding of the issues arising in the current debate on network regulation. It will also assist any future work on the effectiveness of building blocks and assessing possible reforms.

Review Objective

In November 2008, the AEMC initiated this review following a rule change proposal from the Victorian Minister for Energy and Resources which seeks to implement a TFP methodology in the National Electricity Rules.

The objective of the review is to advise the MCE on whether permitting the use of a TFP-based methodology would contribute to the national gas objective (NGO) and/or national electricity objective (NEO) and if so, to provide draft Rules for the MCE's consideration.

Next Steps

This review's final report includes draft rule change proposals for both the electricity and gas regimes. Following consideration of our recommendations, the MCE is asked to decide whether to submit rule change proposals to the AEMC.

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