28 October 2009

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

Via website: www.aemc.gov.au

Dear John,

Review into the use of Total Factor Productivity: Design Discussion Paper

1. Introduction and Overview

Grid Australia welcomes the opportunity to respond to the AEMC's Design Discussion Paper for the Review into the use of total factor productivity (TFP) for the determination of prices and revenue.

Grid Australia comprises transmission networks service providers (TNSPs) ElectraNet Pty Limited, Powerlink Queensland, SP AusNet, Transend Networks Pty Ltd and TransGrid. Collectively, this group owns and operates over 40,000 km of high voltage transmission lines and has assets in service with a current regulatory value in excess of $10 billion. A priority for Grid Australia is ensuring regulatory certainty and stability for both investors and users of the transmission networks.

Grid Australia supports the AEMC's decision to undertake a comprehensive review of TFP issues and only develop draft Rules if it considers that TFP based regulation would contribute to achievement of the National Electricity Objective (NEO) or National Gas Objective (NGO), and the Pricing Principles in the National Electricity Law (NEL). It is recognised that the AEMC is mindful of preserving regulatory certainty and stability in designing a TFP model for review. Grid Australia considers that this is particularly appropriate given that many issues exist around the technical and practical operation of TFP based regulation.

It is clear that further challenging questions relating to input and output measurement and TFP growth rate calculation need to be resolved in the next stages of this review. Some of these were identified by the Expert Panel on Energy Access Pricing and it is notable that the details of the proposed inputs and outputs to be applied to energy network businesses are yet to be settled. It is important that these questions be resolved to enable a proposed TFP regime to be reasonably assessed. The AEMC's approach should assist in this regard.

On 28 August the AEMC published a Design Discussion Paper which sets out a "Straw Man" TFP model for stakeholders to analyse and respond to. The model addresses a number of key design elements related to providing TFP as an option and the operation of a TFP approach.

This submission briefly addresses broad issues raised by the Design Discussion Paper including:

- the need to recognise that TFP is unsuitable for application to the transmission sector;
- the importance of maintaining a stable regulatory environment and the best means of achieving regulatory certainty if seeking to apply TFP as an alternative form of regulation; and
- the need to ensure TNSPs are not required to provide data and information as inputs to a TFP index.

These are discussed in more detail below.

TFP is unsuitable for transmission services

Grid Australia notes that the focus of the Discussion Paper is on the distribution sector and that the possibility of applying a TFP approach to the electricity transmission sector will be considered at a later stage. This is consistent with the Revised Statement of Approach which states:

> ...the AEMC will initially focus on its possible application to the electricity and gas distribution sectors. The views formed in these discussions will assist in assessing the possible application of TFP to the transmission sectors at a later stage in the review process.[1]

It is also consistent with observations made by the Expert Panel such as:

> ... the adoption of TFP-based approaches to access regulation for energy businesses is likely to be a worthwhile development for electricity and gas distribution businesses in particular. The case for TFP appears less compelling in electricity transmission, where significant lumpiness over future capital expenditure demands is an important part of the industry landscape. To the extent that lumpiness of capital expenditure is less a feature of existing gas transmission services, this too may represent an opportunity to develop this price control setting method.[2]

Grid Australia is concerned that while the AEMC is focused on distribution, it is still contemplating applying TFP in a transmission context. Grid Australia reiterates its view that TFP is unsuitable for the economic regulation of transmission networks because:

- the transmission investment requirements can vary significantly from one regulatory control period to another (the profile is 'lumpy'), and prices need to reflect individual business's costs;

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1 AEMC, ***Revised Statement of Approach,*** April 2009, p 9.

2 Expert Panel on Energy Access Pricing, ***Report to the Ministerial Council on Energy,*** April 2006, p 105.

- a key output from transmission systems is reliable service which is more about minimising the risk of service failure which is inherently difficult to measure compared with measuring service interruptions associated with distribution systems;

- it would be impossible to design appropriate output measures in transmission given the wide variation in the physical characteristics of the transmission networks. There are great differences in how much energy is transported, how far it is transported and to what level of reliability the service is provided;

- using an industry wide X-factor as a proxy for setting prices would deliver inappropriate outcomes in terms of revenues, profits and investment; and

- factors such as varying age and mix of assets, jurisdictional planning standards and generation mix make it very difficult to compare firms in electricity transmission.

More detailed discussion of these positions is set out in Grid Australia's response to the Commission's Framework and Issues Paper submitted to this review in February 2009.

Regulatory Certainty

Grid Australia notes that one of the criteria guiding the AEMC's TFP design example in the Discussion Paper is the concept of providing good regulatory practice through clarity, certainty and transparency in the regulatory framework.

Grid Australia considers that regulatory certainty is currently provided in the building block approach and current regulatory framework under Chapter 6A of the Rules. This certainty is brought about by having an established form of regulation, regulatory precedents and an appropriate level of prescription in the Rules in relation to regulatory processes. It is particularly important to include decision-making criteria for the Regulator and to provide clear guidance to be applied by the Regulator when exercising its discretion. This, together with the availability of merits review of regulatory decisions also places discipline on the regulator to ensure the general quality and consistency of its decisions, enhance openness and accountability.

To preserve regulatory certainty it is important that any TFP approach be clearly articulated and prescribed in the Rules to a similar degree. This is especially important given that the TFP approach is new and untested in the Australian energy sector, and is relatively undeveloped elsewhere in its application to energy network regulation. Grid Australia considers that the principles, procedures and mechanics (specification of TFP growth rate, inputs and outputs, weightings, definitions) should be codified in Rules in order to maintain regulatory certainty. Retaining the current processes and timeframes used under the building blocks approach would also be useful in this regard. Grid Australia expects that anything less than this would negatively impact confidence in a TFP approach.

Grid Australia supports the AEMC's proposal to have the adoption of TFP be at the choice of individual businesses. The decision to move to a new form of regulation should not be imposed as this would introduce an unmanageable level of regulatory uncertainty in the regulatory framework. Businesses which are open to an alternative form of regulation can opt in, while risk-averse businesses have the right to stay with the building blocks approach. Grid Australia considers this design feature is crucial to allow the two approaches to operate simultaneously.

Grid Australia also supports the provision for flexibility in a TFP approach in the AEMC's Straw Man model. In particular, the use and design of cost pass-through arrangements, off-ramps and capital modules appears to allow for individual businesses to accommodate their specific circumstances and manage risk.

Data and information requirements

The AEMC's Discussion Paper puts forward the idea that a minimum time series of eight years of data would be required before a TFP methodology could be applied to revenue determinations.[3] It is also contemplated that before TFP can be applied, data and information collection requirements will need to be in place to enable the AER to collect sufficient and consistent data of a standard that could be used to make regulatory determinations in a TFP context. However, the detail of information requirements to enable the AER to collect TFP-standard information has not been set out.

Grid Australia strongly considers that TNSPs should not be required to provide data and information as inputs to a TFP index. This would be particularly unreasonable where TFP could not be justifiably applied to electricity transmission.

Grid Australia considers that should any reforms to the Rules and the AER's regulatory information requirements be proposed as a result of this review, they must be carefully considered and thoroughly consulted upon with industry and stakeholders to ensure that they are justified and appropriate.

Conclusion

Grid Australia considers that:

- TFP is clearly inappropriate for regulating transmission networks;
- any TFP alternative framework needs to maintain the current levels of regulatory certainty and clarity; and
- any additional information requirements to implement TFP for distribution must not automatically extend to TNSPs.

Grid Australia looks forward to engaging further with the AEMC and stakeholders in the relation to this review. If you require any further information from Grid Australia, please do not hesitate to contact me on 08 8404 7983.

Yours sincerely,

Rainer Korte
Chairman
Grid Australia Regulatory Managers Group

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[3] AEMC, ***TFP Design Discussion Paper***, 28 August 2009, p 32.