ActewAGL Always.

ActewAGL House 221 London Circuit Canberra ACT 2600 ▪ GPO Box 366 Canberra ACT 2601
Telephone 13 14 93 **Facsimile** 02 6249 7237 *www.actewagl.com.au*

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Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box H166
AUSTRALIA SQUARE NSW 1215

By email: submissions@AEMC.gov.au

Dear Dr Tamblyn

Response to AEMC Total Factor Productivity Preliminary Findings Paper

ActewAGL Distribution appreciates the opportunity to comment on the Australian Energy Market Commission's (AEMC's) *Review into the use of Total Factor Productivity for determination of prices and revenues – Preliminary Findings.*

As the owner and operator of the ACT electricity and gas distribution networks, which have recently been the subject of determinations by the Australian Energy Regulator (AER) under the National Electricity Rules (NER) and National Gas Rules (NGR), ActewAGL Distribution is keenly aware of the strengths and weaknesses of the current building block approach. Reforms over the past few years have strengthened the building block approach in several ways – for example, the NER and NGR now clearly set out the criteria to be applied by the AER in assessing building block proposals, the factors to be considered and the limits of the AER's discretion. However, there are still significant shortcomings, as the AEMC has identified at earlier stages of the total factor productivity (TFP) review.[1] ActewAGL Distribution therefore fully supports consideration of alternatives and improvements to the current building blocks approach.

However, ActewAGL Distribution is concerned about the scope of the AEMC's TFP review and the timing and nature of any changes to the Rules to implement a new TFP methodology. ActewAGL Distribution considers that it would be premature for the AEMC to progress to stage 2 of the review and develop draft Rules at this stage. The AEMC's timeline indicates that the stage 2 report on draft Rules would be finalised, if required, by September 2010.[2] Given the significant uncertainties and risks involved, ActewAGL Distribution considers that the scope of the review should be broadened and the timeframe for any Rule changes should be extended.

[1] AEMC 2009, *Review into the use of total factor productivity for the determination of prices and revenues: perspectives on the building block approach*, 30 July.
[2] AEMC 2009, *Preliminary Findings, Review into the use of total factor productivity for the determination of prices and revenues,* 17 December, p. 95.

ActewAGL Distribution notes that the AEMC recognises there are risks with the approach of including a TFP methodology in the NER and NGR, and it therefore seeks stakeholder comment on whether alternatives, such as amendments or other alternatives to the current building block approach that could improve regulatory outcomes, should be explored before a commitment to a TFP methodology is made.[3]

ActewAGL Distribution considers that the risks of introducing a new TFP methodology in the short term are significant. For example, Rule changes to implement a TFP methodology are being considered against a backdrop of ongoing fundamental changes to the regulatory framework for energy networks as well as considerable uncertainty about future policy settings. The first round of AER determinations under the new national regulatory framework is not yet complete, and government climate change policies with potentially significant, and highly uncertain, implications for energy network businesses are being developed.

Against this backdrop, it is very difficult to determine whether and to what extent introducing a new TFP methodology will help to create a better regulatory framework. Experience with the current building blocks approach is still relatively limited, and this approach is likely to evolve over the next few years. The AEMC says that its counterfactual for assessing the TFP option is no change to the present building block approach for gas and electricity.[4] However, ActewAGL Distribution considers that there is a significant risk that this approach will provide a misleading comparison. The AEMC acknowledges that in the time it will take for the methodology to become operational, significant changes in the industry may occur that could have implications for the effectiveness of a TFP methodology.[5] These potential implications should be explicitly addressed in the assessment.

While the benefits of introducing new Rules to implement TFP are uncertain, the costs are likely to be significant. The TFP methodology would not be available for at least 8 years, but new reporting requirements would be imposed in the short term on all the regulated businesses. The AEMC says that it is not proposing that more regulatory data be collected, and it does not anticipate that the reporting requirements would become onerous.[6] However, the AEMC recognises that the existing data sets are inadequate and new information gathering powers may be necessary, implying that more information needs to be collected. Based on the lists of required variables, provided in appendix E of the *Preliminary Findings*, ActewAGL Distribution considers that the additional costs will be significant, particularly for relatively small network businesses. There is a risk that these costs will be borne by all the network businesses, for limited benefit.

ActewAGL Distribution agrees with the AEMC's point that introducing a TFP methodology as an optional alternative, rather than a mandatory requirement, would result in less distortion and risks to the market and would provide time for the

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[3] AEMC 2009, *Preliminary Findings, Review into the use of total factor productivity for the determination of prices and revenues,* 17 December, pp. xii-xiii.
[4] AEMC 2009, *Preliminary Findings*, p. x.
[5] AEMC 2009, *Preliminary Findings*, p. xii.
[6] AEMC 2009, *Preliminary Findings*, pp. xii.

methodology to be tested.[7] However, the AEMC proposes that the ability for businesses to opt out of the TFP method should be constrained. The AEMC's reasons for limiting the scope for businesses to opt out are not well founded. The AEMC says that firms will have an incentive to conserve on their expenditures under the TFP methodology and then apply to revert back to the building block approach to recover these costs. However, this reasoning fails to recognise the existing mechanisms and constraints, such as the service target performance incentive scheme and licence conditions, which should prevent this happening. While the benefits of constraining the ability to opt out are doubtful, it will clearly make the TFP method a more risky and therefore less attractive option for network businesses.

In light of these significant risks and uncertainties, ActewAGL Distribution believes that the AER should broaden the scope of its review to explore other alternatives such as improving the current building block approach. ActewAGL Distribution welcomes the AEMC's commissioning of the Brattle Group report *Options for reforming the building blocks approach*. However, the Brattle Group acknowledges that its review of options is not comprehensive. ActewAGL Distribution considers that the case for introducing a TFP methodology should be assessed in the context of a broader review of future options for the regulatory framework. This more comprehensive review should also be informed by the practical outcomes and experiences from a full round of price resets under the current building block approach.

Please contact Leanne Holmes, Manager Network Regulation (0412 850715) if you would like to discuss our comments.

Yours sincerely

David Graham
Director Regulatory Affairs and Pricing

[7] AEMC 2009, *Preliminary Findings*, p. 31.