

21 July 2009

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

By email: submissions@aemc.gov.au

Dear John,

Review into the use of Total Factor Productivity: Consultants' Reports

Introduction and Overview

Grid Australia welcomes the opportunity to respond to the AEMC's Consultants' Reports on the use of total factor productivity (TFP) published in June 2009. These reports are:

1. ***Incentives Under TFP-Based and Building-Blocks Type Price Controls*** by The Brattle Group (Drs Toby Brown and Boaz Moselle);
2. ***Assessment Of Data Currently Available to Support TFP-Based Network Regulation*** by Economic Insights (Denis Lawrence and John Kain); and
3. ***Energy Network TFP Sensitivity Analysis*** by Economic Insights (Denis Lawrence).

Grid Australia provides the following comments in relation to the key points and findings of these reports.

Incentives under TFP and Building Blocks

The Brattle Group's report compares the incentive properties of the current building blocks approach applied by the AER against the specific TFP model of the Victorian Government's 2008 Rule change proposal. In comparing the strength of incentives under the two approaches, the Brattle Group concludes that TFP provides only a marginally stronger incentive for businesses to control costs. However, where the incentive to control costs is greater, a smaller proportion of cost savings would be expected to be shared with users. Grid Australia notes that the balance between the incentives to reduce costs and share savings with users can be addressed by adjustments to the efficiency benefit sharing mechanism.

TFP relies upon the extent to which firms can be reasonably compared to one another. The Report observes that the existence of multiple jurisdictions, geographical factors and other external factors that may be significant cost factors may make this difficult in Australia.¹ Grid Australia agrees with this point and emphasises that this is particularly true for electricity transmission where significantly different geographical and physical characteristics can prevent a valid comparison of networks. This is reflected in the AER's Electricity Transmission Regulatory Report, which notes that "the circumstances in which TNSPs deliver their services may differ dramatically."² Factors such as the age and mix of assets, environmental factors, jurisdictional planning standards and generation mix need to be considered when comparing the performance of different TNSPs.³

Availability of data in transmission sector

Grid Australia notes that an approach based on TFP requires a complete and robust data-set to build the TFP index. In assessing the availability of data to implement a TFP approach, Economic Insights notes that:⁴

- more relevant data exists for the electricity distribution sector than for the other three sectors examined (i.e. electricity transmission and gas transmission and distribution);
- currently available regulatory data is primarily financial data and limited data exists on physical aspects such as system characteristics and outputs. These data gaps and inconsistencies would limit the regulator's ability to normalise data for operating environment differences across businesses adequately; and
- much of the regulatory data is not in the public domain and as such does not allow stakeholders to test its veracity.

The Report concludes that the available regulatory data is not fit for use in TFP analysis of the standard required for regulatory determinations.

Grid Australia agrees with this conclusion, which effectively means that there is insufficient information available to support a TFP approach in the near future. Given Economic Insights' assessment is based on electricity distribution data which is much more readily available than transmission data; it is likely that information availability would be an even greater problem in transmission.

Economic Insights has suggested the AER should collect information to develop a TFP database. 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.

¹ The Brattle Group (Toby Brown and Boaz Moselle), *Incentives Under TFP-Based and Building-Blocks Type Price Controls*, June 2009, p49.

² AER, *Transmission Network Service Providers: Electricity Regulatory Report 2006/07*, p16

³ Ibid, pp16-17.

⁴ Economic Insights (Denis Lawrence and John Kain), *Assessment Of Data Currently Available To Support TFP-Based Network Regulation*, June 2009, pv.

Grid Australia also cautions against making any assumptions that providing additional data would not result in an extra regulatory burden for businesses until such time as the businesses understand and have had an opportunity to assess any potential information requirements put forward.

TFP Sensitivity

Economic Insights' Report confirms that a TFP-based regulatory approach would be sensitive to the specifications chosen and the method used to calculate growth rates. Grid Australia considers that the specification of inputs, outputs and methodology in relation to setting the TFP index is therefore likely to be highly contentious and may not necessarily result in reduced regulatory costs compared to a building block regulatory review.

Conclusion

Grid Australia considers that the overall findings of the AEMC's Consultant's Reports are:

- the perceived benefits of TFP may be limited as:
 - TFP provides only a marginally stronger incentive to control costs; and
 - developing a TFP index is likely to be highly contentious and may not necessarily result in reduced regulatory costs.
- there are practical difficulties in applying TFP because:
 - the existence of multiple jurisdictions and geographical factors may make it difficult to apply TFP in Australia (this is particularly the case for electricity transmission); and
 - the regulatory data currently available is not suitable for use in TFP analysis of the standard required for regulatory determinations.

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