# Assessing a TFP methodology

Review into the use of total factor productivity for the determination of prices and revenues

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Workshops on the design discussion paper

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# Agenda

- Draft Report on TFP due in early December

- Presentation to inform on AEMC approach to addressing Review objectives

- <u>Structure of presentation</u>

  - Review Objectives
  - Assessment Framework
  - Economic considerations
  - Practical application considerations
  - Industry specific issues

# Review Objectives

To advise MCE on:

- the circumstances in which an application of a TFP based price setting methodology would contribute to the NEL and NGL objectives

- whether it is efficient to allow a TFP methodology as an **<u>alternative option</u>** to the current building blocks methodology

- the arrangements including information, reporting and data requirements that need to be put in place to facilitate its application

- if appropriate, the development of proposed rules to support the applications of a TFP based form of control for any individual or group of electricity or gas distribution or transmission service providers.

# Assessment Framework

- Two stages to assessment:

  a) Test the efficiency of a TFP methodology under ideal conditions (i.e., no problems with available data set and TFP calculation) against NEO/NGO and revenue and pricing principles

  b) Weaken data and TFP calculation assumptions and look at the practical application

- A TFP methodology can be applied in many ways.  Use straw-man TFP design as test model.  Then check results with ESC and Victorian DPI proposed models

- Current application of building blocks is counterfactual (AEMC Perspective's Report)

- Focus on distribution sectors (electricity and gas)

- Consider TFP as a benchmarking tool to inform building blocks

# Economic considerations (1)

- Strength of incentives for cost efficiencies and the extent that they are shared with users

  - Po method may be more important
  - Efficiency Carryover Mechanism difficult to apply to TFP

- Ability of the business to recover efficient costs

  - Use of capital module, off-ramps, cost pass through

- Promotion of long term efficient investment

  - Ability to finance the provision of services under current conditions
  - Treatment of sunk costs

# Economic considerations (2)

- Promotion of innovation (and energy efficiency) goals

- Issues with providing a choice between alternative methodologies (optionality)

- Costs and risks of regulation

- Quality of Service


- Are there alternative models, or improvements to the building block approach, that could better contribute to the promotion of the NEO/NGO?

# Practical application considerations

- Availability of data-set (Economic Insights Report)

- Likely industry participation

- Issues with TFP index calculation

- Future conditions for businesses (NAS report)

- Lessons from overseas TFP applications (Brattle International Case Studies Report)

- Views from stakeholders

# Gas Specific Issues

- Building blocks applied differently in electricity than gas (prudency assessment, ability to re-open)

- Less challenges arising from climate change

- New market structures

- Expenditure likely to be more stable going forward

- Existing data – not as good as electricity distribution

- Common ownership

- Number of regulated industry business smaller
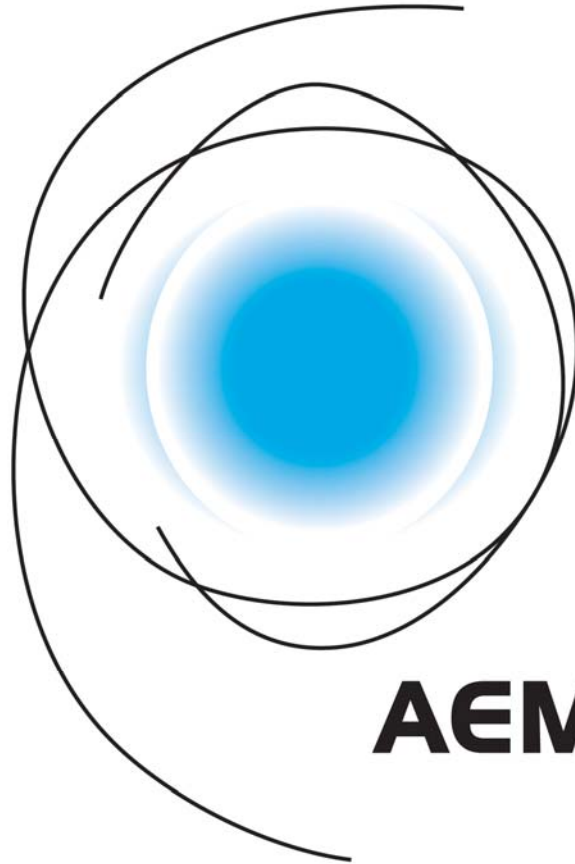
# Electricity Specific Issues

- Building blocks applied differently in electricity than gas (no prudency assessment)

- Climate change challenges

- Reported significant increases in capital expenditure (replacement and augmentation)

- Expenditure to maintain jurisdictional reliability standards

- Variations in classification of services

- Existing data – slightly better

# WAY FORWARD

- Submissions are invited on:

  - consultant reports
  - Design discussion paper

- Submissions are to be lodged through the AEMC website by Friday 30 October 2009

- Stage 1 draft report is scheduled for release in December 2009

- Public forum on the draft report is scheduled for late January 2010

**AEMC**