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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*

24 December 2010

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box H166
AUSTRALIA SQUARE NSW 1215

By email: submissions@AEMC.gov.au

Dear Mr Pierce

Response to AEMC Total Factor Productivity Draft Report

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 – Draft Report.* ActewAGL Distribution fully supports consideration of alternatives and improvements to the current building blocks approach. However, as explained in our previous submissions, ActewAGL Distribution considers that it would be premature for the AEMC to develop draft Rules to introduce a total factor productivity (TFP) methodology at this stage.

ActewAGL Distribution therefore supports the AEMC's draft conclusion to adopt a 2 stage approach to the remainder of the review, establishing in stage 1 whether a set of necessary pre-conditions for effective and efficient implementation of a TFP methodology are met, then progressing in stage 2 to prepare draft Rules for implementation only if those conditions are met.

While ActewAGL Distribution supports this broad approach, we have a number of comments and concerns in relation to the AEMC's draft findings.

New data collection requirements

The focus in stage 1 would be on establishing a robust and consistent data set. While ActewAGL Distribution accepts that such a data set is a critical requirement for effective implementation of a TFP methodology, we are concerned that the AEMC has underestimated the potential difficulty and cost associated with establishing such a data set.

The AEMC has highlighted the significant shortcomings of existing data sets, yet it considers that the costs of aligning reporting practices and developing the new consistent data set "should be marginal".[1] The AEMC also recognises that establishment of a robust regulatory reporting regime may take significant resources, and could require IT system changes. However, it "does not consider this to be significant given that the type of the physical and financial data required for TFP should already be calculated by the service providers". [2]

While there is no indication in the *Draft Report* of the data that may be required, based on the lists of required variables provided in appendix E of the January 2010 *Preliminary Findings*, ActewAGL Distribution considers that the additional costs will be significant, particularly for relatively small network businesses. In addition to the costs of establishing new reporting systems, there would be significant time and cost involved in developing a consistent set of definitions and required variables. As the AEMC has noted in the *Draft Report*, the difficulties the AER has had in populating its historic Regulatory Information Notices in recent regulatory reviews is indicative of the difficulties that would be encountered.[3]

ActewAGL Distribution is also concerned about the potential for overlap and duplication with the AER's existing and potential annual reporting requirements. Referring to the AER's 2008 *Issues Paper*, the AEMC notes that "an augmented annual reporting program is also expected to operate under the building block approach", and "such an approach should also include provision of TFP-relevant information".[4] ActewAGL Distribution notes that there is considerable uncertainty surrounding the AER's future annual reporting requirements, as reflected in the apparent stalling of the process following the release of the AER's *Issues Paper* in 2008. Adding further requirements relating to "TFP-relevant information" is likely to complicate an already difficult process.

Further conditions to be met before a TFP methodology could be applied

In addition to a robust and consistent data set, the AEMC identifies two further conditions that must be met before a TFP methodology could be applied:

1. That the TFP growth index is likely to be a reasonable estimate of future potential productivity growth of the industry growth; and
2. Service providers within an industry group face comparable productivity growth prospects.[5]

In relation to the first requirement, the AEMC explains that conditions facing service providers must be relatively stable over time, so that historic TFP growth rates are a reasonable estimate of potential future productivity growth. The AEMC notes industry concerns that this requirement is unlikely to be met, as service providers face a number of potentially significant changes, for example changes related to the introduction of smart grids and policies to address climate change, which will make future conditions less stable than past conditions.

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[1] AEMC 2010 *Review into the use of total factor productivity for the determination of prices and revenues – Draft Report (Draft Report)*, p. iii
[2] AEMC 2010 *Draft Report*, p. 55
[3] AEMC 2010 *Draft Report*, p. 66
[4] AEMC 2010 *Draft Report*, p. 55
[5] AEMC 2010 *Draft Report*, p. 101

ActewAGL Distribution is concerned that the AEMC is too dismissive of these concerns. The AEMC refers to an AER study of the potential implications of climate change policies which finds that:

> "Service providers would not be subject to changes in their operating environments that would have a material impact on operating expenditure over the next regulatory period."[6]

ActewAGL Distribution considers that further analysis is required on the possible implications of ongoing and potential changes in energy markets, and whether and how the TFP methodology could deal with such changes.

ActewAGL Distribution also considers that further empirical research is needed in relation to the second requirement – that is, whether all service providers within an industry group face comparable productivity growth prospects. A key issue here is whether differences in operating conditions affect productivity growth prospects. Some differences between service providers can be accommodated through the setting of different initial price levels. However, if growth prospects differ among firms then further measures such as splitting industry groups would need to be considered.

The AEMC notes in the *Draft Report* that, while there are some preliminary indications that operating conditions, such as customer density, geographic location and spread, may not significantly influence TFP growth rates, further empirical testing is required.[7] ActewAGL Distribution agrees that further work is required in this area.

Improving the building block approach

The AEMC indicated in the *Preliminary Positions* paper that its approach in the review was to compare the TFP option with the existing building block approach. The Energy Networks Association pointed out industry concern with this approach, and suggested that the AEMC's assessment needs to recognise the potential for the building block approach to evolve over time. ActewAGL Distribution also argued 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.

In the *Draft Report* the AEMC says it will continue to assess and review the operation of the current building block approach over the short term. The AEMC explains that it will observe developments and application of the NER and NGR by the Australian Competition Tribunal, as part of the process of gathering information on the possible improvements and developments that can be made in the regulation of energy infrastructure.[8]

ActewAGL Distribution welcomes the AEMC's intention to assess and review possible improvements and developments. However, from the AEMC's discussion in

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[6] AEMC 2010 *Draft Report*, p. 102
[7] AEMC 2010 *Draft Report*, p. 77
[8] AEMC 2010 *Draft Report*, p. 7

the *Draft Report* of the way forward, it is not clear how this assessment and review process will be incorporated into the current review.

ActewAGL Distribution looks forward to ongoing engagement with the AEMC and other stakeholders during the remainder of this review. If you would like to discuss any aspect of our submission please contact Leanne Holmes, Manager Economic Regulation, on 0412 850715.

Yours sincerely

David Graham
Director Regulatory Affairs and Pricing