

27 February 2009

Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear John,

Review into the use of total factor productivity: Framework and Issues Paper

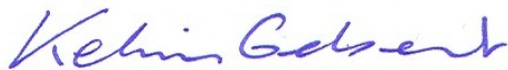
SP AusNet supports the AEMC's establishment of a review considering the use of total factor productivity (TFP) for the determination of prices, and provides the attached submission in response to the Framework and Issues Paper.

This review provides an opportunity to thoroughly consider and explore an alternative regulatory framework. SP AusNet encourages the AEMC to take a holistic and forward looking approach towards this review with a view to considering the future of economic regulation. Given the growing maturity of economic regulation in Australia and the body of experience that is building internationally, this review should examine forms of TFP that would deliver greater efficiency and network performance, whilst being capable of dealing with the emerging needs of the energy network sector.

In broad terms, a lighter-handed and progressive form of TFP has the potential to deliver substantial benefits to customers and regulated companies through more powerful incentives for efficiency and the lowering of costs associated with regulation. However a TFP model that draws largely from a building blocks approach would be unlikely to deliver any benefits above those already provided by the current approach and SP AusNet would not support this type of model.

SP AusNet would be pleased to discuss the attached submission in further detail with you at your convenience.

Yours Sincerely,



Kelvin Gebert

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1. Introduction and Overview

The review seeks to provide advice to the Ministerial Council of Energy (MCE) on the circumstances in which an application of a TFP based price setting methodology would be appropriate.

This review provides an opportunity to undertake a detailed consideration of a lighter form of regulation that has the potential to provide better outcomes to customers and regulated companies. SP AusNet considers a TFP regime in a progressive form is an option worthy of consideration. Moreover, SP AusNet sees the benefits of the TFP approach in terms of “growing the pie” rather than re-cutting the shares between customers and industry. SP AusNet submits that an optimal TFP regime which provides a true alternative to building blocks would have the potential to:

- retain the incentive strengths and features of a pure TFP approach;
- deliver efficiency and saving benefits to users and businesses over the long term; and
- deliver a lighter form of regulation and lower administrative costs.

SP AusNet does not support forms of TFP which are based on a building blocks approach as these do not provide a true alternative to the current approach, which will be retained.

These points are discussed further in the body of this submission which is structured as follows:

- Section 2 discusses the scope of the review and assessment framework;
- Section 3 discusses the potential benefits of TFP to the market;
- Section 4 the design of a TFP based approach which SP AusNet considers will deliver benefits;
- Section 5 discusses the potential application of TFP;
- Section 6 recommends transitional measures; and
- Section 7 provides our concluding comments.

In addition, Attachment 1 provides responses to selected questions in the AEMC’s list of issues.

2. Scope of the review and assessment framework

2.1 Scope

The AEMC's review is broad in its scope and SP AusNet notes that the review is looking at TFP as an addition to building blocks, not a replacement. SP AusNet considers the AEMC has correctly set the scope of the review to include providing for the specification and use of TFP indices for benchmarking as well as the full application of TFP. It is a realistic starting point - if TFP is considered to have merit as an alternative approach, transitional measures and data-collection will be necessary to transition businesses towards a new regulatory approach.

SP AusNet supports the broad approach taken in this review and recommends that the next step be the development of an ideal 'straw man' TFP model so that stakeholders may comprehensively respond to a potential model for application. This would facilitate greater analysis and assessment. SP AusNet recommends some basic features of an ideal model TFP regime in section 4 of this submission.

2.2 Assessment criterion

SP AusNet considers the AEMC's assessment criterion for the review are appropriate and recommends the AEMC have regard to its first two criteria in particular, that is:

- the strength of the incentives on the service provider to pursue cost efficiencies and the extent to which such cost efficiencies are shared with end-users; and
- the ability of the framework to ensure efficient investment to promote long term innovation and technical progress for the benefit of the service provider and end-users.

However SP AusNet questions the AEMC's decision to make an assessment of TFP based on whether it would **better** contribute to the achievement of the national objectives while meeting the revenue and pricing principles. However, if the right TFP model could deliver **equally good** outcomes for businesses and consumers, then having two alternative models would still advance regulatory objectives. In principle, there should be no reason to limit the regulatory framework to one single approach. Further, there may be optional value in providing TFP as an alternative as it would apply different incentives and drivers which may suit certain circumstances or businesses better than building blocks. .

SP AusNet encourages the AEMC to undertake this project with a view to considering the future of economic regulation. Recognising the growing body of experience that is building in economic regulation, it may be timely to review the means by which energy networks are regulated to see if alternative approaches may provide further efficiency and performance improvements. It is recommended that a new regulatory approach be:

- light handed and less administratively burdensome;
- able to provide incentives for enhanced service delivery and greater efficiencies across the sector;
- sufficiently flexible to allow it to deal with changing business drivers and opportunities;
- supportive and encouraging of innovations in the energy network sector; and

- able to support the future sustainability of the sector.

3. The potential benefits of TFP

A TFP index is used to determine the X-factor under a CPI-X approach to price cap incentive regulation. In a true TFP alternative, once an initial price level (P_0) is set, prices are adjusted thereafter in accordance with the TFP growth factor. This would be a fluid arrangement without regulatory control periods i.e. in a true alternative to building blocks, incentives for businesses to produce efficiencies would not be limited by periodic initial price level resets. The mechanism for re-aligning prices back to actual costs should be through the trigger of 'off-ramps' designed to protect users and businesses against undesirable exogenous events or market trends. Consistent with incentive regulation, TFP can therefore be used to de-link prices from firm-specific costs to drive greater productivity.

TFP rewards firms that outperform the industry-wide productivity trend with higher profits. The intention is that this creates an incentive to achieve dynamic efficiencies, driving industry-wide cost savings that are passed on to consumers. In having firms compete to perform better relative to one another, TFP seeks to mimic the operation of competitive markets – where prices adjust (up and down) to changes in long run average unit costs for the industry. The expectation is that all firms will respond, and in this way, a TFP approach holds the potential to “grow the pie” rather than re-cut the shares between customers and industry.

SP AusNet considers that the adoption of a TFP regime which represents a true alternative to a building blocks approach has the potential to deliver significant benefits to users and distribution businesses by:

- strengthening incentives on businesses to achieve dynamic efficiencies. This is because firms would be driven to outperform an industry-wide cost and service delivery benchmark to achieve rewards. A key component of the incentive properties of the TFP regime lies in the ability to have long or indefinite regulatory periods which places the efficiency sharing mechanism clearly in the X factor. This creates greater certainty for businesses on their long term prices and will facilitate innovation and research and development beyond what is currently undertaken;
- delivering the benefits of productivity growth over time to users in the form of slower price growth. This is because firms would be incentivised to achieve productive efficiencies, driving industry-wide cost savings would result in prices trending downwards as unit costs for the industry decrease. These savings would be passed on to consumers;
- reducing the regulatory burden to both the regulator and businesses by:
 - using known and measurable information instead of relying on firm specific forecasts; and
 - reducing the frequency of resource-intensive regulatory reviews.

This would reduce regulatory costs as the number of price determination processes would decrease, relieving parties from extremely resource-intensive processes.

The AEMC has also noted in its Framework and Issues Paper that a TFP approach could:

- mean less likelihood of disputes (provided there is a generally accepted TFP methodology) since the allowed price path would be based upon known and measurable historical industry wide data;
- help to overcome information asymmetry issues between the Regulator and businesses in terms of forecasting cost and volume trends; and
- overcome the substitution problem between operating expenditure and capital expenditure which exists under the building block approach.¹

In addition to these factors, a TFP approach would encourage greater innovation by businesses and more investment in new non-network solutions. The AEMC has correctly observed that

TFP based methodologies can make the service provider revenue less dependent upon the RAB and therefore can overcome the possible disincentive on businesses not to pursue non-network options as an alternative to capital expenditure.²

A TFP control setting method offers the greatest potential benefit when:

- the businesses or industry being regulated is in a relatively steady state. This is so that a long term estimate of TFP represents a relatively good estimator of future cost and/or demand changes; and
- the industry has reached a point where its forward-looking capital expenditure has a relatively smooth profile.

The gas and electricity distribution sectors fit this description well. The sectors have been relatively stable and investment has been consistent. Further, regulatory experience is established in these sectors with most distribution businesses in the NEM scheduled to complete their third round of regulatory reviews over the next two years.

4. Designing TFP based approaches

SP AusNet considers that a TFP regime design which could best deliver the above benefits would involve:

- a light-handed TFP approach where incentives are not constrained. This would require an arrangement where there would be indefinite or long regulatory periods. This would be supported by off ramps with clear criteria/triggers to realign prices with actual costs;
- an agreed and transparent TFP growth factor estimation methodology;
- adequate data to feed the TFP index and sound data collection and analysis tools for the regulator to build the TFP index, including an effective means of treating data from 'outlier' or atypical firms;

¹ AEMC, Framework and Issues Paper, December 2008, p 37

² AEMC, Framework and Issues Paper, December 2008, p 37

- a fair and reasonable TFP X-factor based on long term data; and
- a means to accommodate important differences between businesses and their potential to respond to the incentives provided under a TFP regime such as graduated 'bands' for off ramps or earnings sharing mechanisms triggers.

SP AusNet notes that TFP regimes that have been applied internationally, and the designs that have been discussed for use in Australia, are all hybrid models partly based on building block elements such as fixed regulatory periods and/or regular P_0 resets.

In SP AusNet's view, the frequent re-setting of prices to reflect costs would undermine the potential benefits of the TFP approach by weakening incentives for efficiencies. This was noted by the Expert Panel in identifying "best practice" elements for a TFP price control setting method to be included in guiding principles for TFP³:

"This guidance should include the need for a TFP control setting method to ensure:

- [3rd bullet] the abolition of any specification of the minimum (or maximum) regulatory period. An important benefit of a TFP approach to control setting is the potential flexibility to set longer regulatory periods than the current five year approach, perhaps in conjunction with the use of off-ramps linked to whether or not actual rates of return are within a prescribed band"

SP AusNet notes the strength of the incentives depends on the extent to which firms may earn more than the target rate of return and the extent to which those returns are able to be retained by the firm in subsequent regulatory periods. Fixed-term building block approaches specify the duration of the control place limits on the extent to which achieved returns may exceed the target through limited capex and opex provisions and incentive sharing schemes. By contrast, a 'set and forget' TFP-based approach would not fix a control period, but would impose bands around the target rate of return beyond which an achieved rate of return could trigger a cost-based review and P_0 reset.

Any TFP approach considered for introduction should provide a genuine alternative to building block regulation. The alternatives must be different- there would be no real benefit in providing options that are similar as they would drive the same behaviours and provide similar level incentives.

5. Application of TFP

One of the fundamental questions for this review is "under what circumstances would it be appropriate to allow a TFP based methodology for any group of service providers?" In principle, TFP becomes an appropriate regulatory approach where:

- *It is a regulatory objective to strengthen incentives for dynamic and productive efficiencies.* SP AusNet considers that there are benefits for the market in strengthening the incentives for efficiency and this should be a constant objective for policy makers and regulators, balanced against maintaining service quality;
- *There is interest in reducing the costs of regulation and minimizing the intrusiveness of the regulatory process.* SP AusNet considers this should be a constant objective of regulatory reforms. The creation of the AER as a national regulator is intended to

³ Expert Panel on Energy Access Pricing, Final Report to the MCE, April 2006, page 109.

provide a more efficient institutional arrangement by streamlining energy regulation. The next phase of regulatory reform should look to moving towards a less resource-intensive and intrusive approach to regulation which continues to effectively deliver value to consumers whilst providing regulatory certainty for businesses to continue to invest;

- *Adequate data is available to aggregate and use as a basis for an index.* Whether there is adequate data available to develop a TFP index may be assessed based on a stocktake of all the data and information that has been accumulated from the businesses and Regulators from the last decade of regulatory reviews. Cost performance over that period could form a sound basis for establishing benchmarks. Moreover, as the AER grows in its experience in regulating distribution on a national level, it will hold valuable information on expenditure and service delivery performance which could be used for aggregation and analysis;
- *Differences between regulated businesses in relation to the relative efficiency levels or ability to respond to incentives are able to be dealt with by an agreed method.* Differentiation between businesses may be necessary. SP AusNet considers that mechanisms could be designed to accommodate important differences between businesses and their potential to respond to the incentives provided under a TFP regime. The AEMC acknowledged this in the Framework and Issues Paper:

Another potential disadvantage of the TFP approach is that by setting the businesses' allowed revenues based upon an external benchmark instead of using business specific data, the risk is increased of businesses either not being able to recover their efficient costs or making excess returns. However, the design of the TFP methodology can include safeguards against these outcomes.⁴

- *Stakeholders accept fluctuations in returns for businesses due to the approach relying upon individual performance results.* Consistent with any strengthening of incentives is the possibility of fluctuations in returns to businesses. The level of tolerance for fluctuations in returns is an issue that needs to be considered by policymakers and businesses. SP AusNet notes that any perceived risk associated with fluctuating returns could be mitigated by determinations by the Regulator on what level of returns it would consider acceptable (in designing off ramp triggers). This would require a willingness on the part of the AER to provide its views on acceptable levels of returns.

SP AusNet considers the criteria for introduction of TFP are therefore broadly met and believes the exploration of a true TFP alternative is appropriate. Enabling such an alternative to apply to gas and electricity distribution businesses would provide an important and welcome improvement to the existing Rules. SP AusNet considers that it cannot reach a conclusion as to the merit of applying TFP until it is provided a 'straw man' TFP model to assess.

4.1 TFP and lumpy investment

TFP is most suited to an industry that operates in a relatively 'steady state.' A TFP approach would be less suited to the transmission sector, particularly as the investment profile of transmission is lumpy and uncertain. Prices and revenues in these circumstances are more appropriately tied to firm-specific costs which may vary significantly from year to year. SP AusNet refers the AEMC to GridAustralia's submission for a further explanation of why TFP should not be considered for transmission.

⁴ AEMC, Framework and Issues Paper, December 2008, p 38

Similarly, SP AusNet notes that concerns may exist in relation to applying TFP to electricity distribution businesses which expect step changes in capital expenditure in the short term to roll out smart metering infrastructure. It is likely that this would be a once-off expenditure which is not typical of a distribution business's expenditure program. A TFP regime would need to provide certainty to businesses for such situations. In this review the AEMC could consider how a TFP approach can be designed to accommodate significant uncertainty surrounding a business's future expenditure requirements. The Expert Panel considered that this would involve some combination of:

- off-ramps that involve relatively narrow bands around the target rate of return; and
- clear commitment to reset initial prices that take account of past expenditure.⁵

However it should be noted that as a means of re-aligning prices with costs, all of these above measures reduce the incentives to achieve productive efficiency gains. A decision would need to be made in reference to managing any risk of expenditure significantly deviating from benchmarks as part of the TFP model design or at the time of the event.

SP notes that the above issue is unlikely to exist in gas distribution which continues to operate in a relatively stable environment.

6. Concluding comments

SP AusNet encourages the consideration of a TFP alternative which includes the features set out in section 4 of this submission.

In broad terms, TFP provides a means of delivering substantial benefits to customers and regulated companies through the provision of more powerful incentives and the lowering of costs associated with regulation.

However, any TFP model to be considered as part of this review should be a genuine alternative to building block regulation. Modified forms of TFP which largely resemble a building blocks approach should be treated with caution because they would be unlikely to deliver any benefits above those already provided by the current approach.

SP AusNet supports the consideration of measures to allow for the use of a benchmark-informed building block approach to facilitate the transition towards a TFP regulatory approach as part of the review.

⁵ Expert Panel on Energy Access Pricing, Final Report to the MCE, April 2006, page 105

7. Attachment 1

	Chapter	Comment
	Scope of the review	
1	Is the Commission's proposed scope of the Review appropriate?	Yes, however the review should focus on TFP in distribution. TFP is less suited to transmission for the reasons outlined in section 4.1 of this submission.
	Assessment framework	
2	Are the Commission's proposed assessment criteria appropriate? Are there other desirable criteria?	The assessment criteria are generally appropriate. Please also see body of our submission for discussion.
3	Designing TFP based approaches	Section 4 in the body of this submission describes design features which SP AusNet believes should be considered by the AEMC in its review.
4	<p>What is the appropriate method for determining TFP growth estimates?</p> <p>(a) How should the outputs and inputs for the different energy sectors be classified?</p> <p>(b) What should be the approach for determining the weightings for inputs and outputs?</p> <p>What are the variables that would be needed to compute a TFP growth estimate for the gas and electricity transmission and distribution sectors?</p>	<p>SP AusNet notes that the X factor calculation may be expressed as:</p> $X = (\text{TFP growth for the industry} - \text{TFP growth for the economy}) - (\text{Input Price growth for the industry} - \text{Input Price growth for the economy})$ <p>SP AusNet recognises that this is a contentious area. Whichever method is determined for calculating the inputs into this equation need to effectively measure outputs of production, taking into account network performance and service delivery. The selection of variables and development of categories of inputs and outputs would rely on a sound and practical methodology. Given both inputs and outputs could be valued and costed in numerous ways, determining the ratio of outputs to inputs is likely to raise complex issues that could be addressed through different, but equally valid approaches that would deliver different outcomes. Weightings of inputs and outputs should reflect actual costs and practice. SP AusNet considers answering these questions requires technical expertise and experience – the development of an appropriate method would rely on expert advice. However it should be noted that DNSPs would need to be able to examine the detail of the applied TFP model to support it.</p>
6-9	<p>What is the current availability of TFP-relevant data and its quality and consistency?</p> <p>If a TFP based approach is adopted, what sample period would be appropriate for the data and what adjustments, if any, would be needed for it to be extrapolated for future circumstances?</p>	<p>SP AusNet considers the selection of an appropriate data set or peer group is an important issue. The outcomes from TFP rely upon relevant and accurate data used in an appropriately designed model.</p> <p>SP AusNet expects that a fair amount of data and information would be available from businesses and Regulators from the last decade of regulatory reviews. However it is up to the Regulator to make an assessment as to the quality and consistency of information available for benchmarking purposes. A longer term data set for the sample period would be</p>

	Chapter	Comment
		preferable.
11	What should be the pre-conditions relating to industry characteristics required for the implementation of a TFP based approach?	<p>TFP would be suited to industries that are in relatively 'steady state' conditions. For example, TFP is much more likely to be suited to distribution than transmission because the distribution sector is comprised of similar network companies operating with fairly smooth expenditure profiles. As discussed in section 5 of this submission, TFP becomes an appropriate regulatory approach where:</p> <ul style="list-style-type: none"> • It is a regulatory objective to strengthen incentives for dynamic and productive efficiencies • There is interest in reducing the costs of regulation and minimizing the intrusiveness of regulatory reviews • Adequate data is available to aggregate and use as a basis for an index • Differences between regulated businesses in relation to the relative abilities to respond to the incentives are able to be dealt with by an agreed method which accommodates important differences • There is a level of tolerance for fluctuations in returns for businesses.
12	If implementing a TRP based approach, should adjustments to an industry wide X be allowed to account for specific business characteristics?	SP AusNet's view is that there may be particular circumstances which make it difficult to deal with firms which do not fit easily into a constructed model of a homogenous industry with standard performance indicators. Given this, a TFP regime may require a means for managing firms' earnings volatility, e.g., by providing different "stretch bands" for firms, which set the parameters for triggering off ramps.
13	If a TFP based approach was introduced, should fixed or rolling X factors be used? Alternatively, should the regulator have the option to choose between these in applying the TFP based methodology.	SP AusNet suggests that the X factor in a TFP regime should be fixed and subject to review periodically. SP AusNet recognises that there is a common view that a longer regulatory period should be accompanied by a rolling X factor. SP AusNet does not support this view. A rolling X factor may impose substantial risk on the DNSP because it exposes the company's revenue to annual assessments of the X factor which will not be mechanistic but complex and possibly contentious. An unpredictable regulatory process of this kind is not desirable within the context of a TFP framework.
14	<p>If a full application of a TFP based approach were to be introduced:</p> <p>(a) Should periodic assessments of efficient costs and the resetting of the X factor be undertaken?</p>	SP AusNet considers that a more genuine alternative to the building block regime would provide for the applicable X factor to be redetermined independent of the need to consider redetermine initial tariffs. It would be more appropriate to redetermine initial tariffs on the basis of prices falling outside of acceptable bands. SP AusNet considers that reverting to a resetting of starting prices should arise from an identified need, rather than by the setting of fixed regulatory periods.

	Chapter	Comment
15	Under a full application TFP approach, what should be the length of the regulatory period?	The power of the incentives would be greatly improved if longer (or indefinite) regulatory periods were adopted. SP AusNet's view, therefore, is that the length of the regulatory period should be at least 10 years, if not more, for there to be strong efficiency incentives. For longer regulatory periods, off-ramps provide a low-cost mechanism for ensuring that the net effect of any unexpected input cost and productivity changes are shared appropriately between the company and its customers. Ideally, TFP would be based on a fluid arrangement with effective off ramps.
16	If a TFP based methodology was introduced, could earnings based re-openers or cost pass through mechanisms be used? What features of these mechanisms would be desirable (or not desirable)?	A mechanism to bring prices and costs back into alignment would be required if the divergence became too great. SP AusNet considers off ramps based on reasonable triggers would be a valid method for managing the risk of price-cost divergence.
17	If a TFP based methodology was introduced, what would be the appropriate index for measuring input prices?	This is a contentious issue and answering this question requires significant technical expertise – the development of an appropriate method will rely on expert advice and experience. SP AusNet suggests that this could be subject to development and assessment of options, with the support of suitable expertise, in the subsequent phase of this review.
19	If a TFP based methodology was introduced, should it be a requirement for service providers to consent to an application of TFP to determine allowed revenue/prices?	<p>Yes. If the right TFP model could deliver equally good outcomes for businesses and consumers as building blocks, then having two alternative models would still advance regulatory objectives. In principle, there should be no reason to limit the regulatory framework to one single approach. Further, there may be optional value in providing TFP as an alternative as it would apply different incentives and drivers which may suit different circumstances or businesses better than building blocks.</p> <p>TFP should not be imposed on businesses by the AER or any other party without their consent. The methodology remains untested in Australia and its application is not simple or uncontroversial. SP AusNet therefore considers the distributor should be provided the opportunity to 'choose' the application of the TFP approach.</p>
20 & 22	<p>Would a TFP based approach be suitable to determine the revenue path for electricity transmission service providers?</p> <p>Would a TFP based approach be suitable for determining the price path for gas transmission pipeline service providers?</p>	A TFP approach would be less suited to regulating the transmission sector as the investment profile of transmission is lumpy and uncertain. In this context, prices and revenues should be more closely tied to firm-specific costs which may vary significantly from year to year. SP AusNet refers the AEMC to GridAustralia's submission on this issue, and reiterates GridAustralia's views on why TFP should not be considered for transmission.

	Chapter	Comment
21 & 23	<p>If a TFP based methodology was to be introduced, should it be applied in electricity distribution determinations?</p> <p>Can a TFP based methodology be applied to the gas distribution sector?</p>	Gas and electricity distribution appear best suited to TFP regulation. TFP based regulation is much more likely to be suited to distribution than transmission because the distribution sector is comprised of similar network companies operating in relatively 'steady state' conditions. This may be even more so for gas distribution.
	Application of TFP	
24	What would be the ability of a TFP based methodology to address any perceived problems with the current applications of the building block approach?	The current building block approach has been criticised for being too resource intensive, requiring subjective judgements by the regulator and having asymmetric information characteristics. TFP could potentially address these issues by providing a lower cost for of regulation, base price levels on a known and measurable TFP growth factor, and remove the ability for regulatory gaming by not requiring decisions on appropriate forecasts of firm-specific costs.
25-27	<p>Under a TFP based approach, what would be the impact on the incentives to make efficiency improvements and make efficient investments?</p> <p>If a TFP based methodology was to be introduced, would the existing incentives schemes be needed? And if so, do they require any amendment?</p> <p>If a TFP based methodology was to be introduced, how should service quality be regulated?</p>	<p>Potentially an effective TFP model would encourage the delivery of efficiency improvements and maintain efficient investment in the networks. See section 3 for further discussion.</p> <p>SP AusNet considers that existing service quality and performance incentive schemes such as the S-factor scheme would need to work in combination with a TFP approach to balance incentives for efficiency and network performance. The AEMC should consider whether TFP regulation should be accompanied by an efficiency benefit sharing scheme. Depending on the design of the scheme, an efficiency benefit sharing scheme may be required.</p>
	Whether to introduce TFP	
28-30	What would be the benefits and costs from having two forms of control in the regulatory framework?	<p>Potential benefits from having two forms of control in the regulatory framework include those benefits that may come from strengthened efficiency incentives and reduced regulatory burden from decreasing the number of intrusive cost-based reviews. Providing for two approaches would also allow for businesses which feel ready for a new approach to test it without committing the whole sector to it. It would allow for a smoother transition, or, if it reveals issues, provide valuable lessons before implementing a new approach across the entire sector. Further, there may be optional value in providing two approaches for businesses to suit different circumstances and provide different drivers and incentives.</p> <p>The costs associated would be the regulatory costs in associated with introducing a new approach (experts and technical resources) the costs to establishing processes for information and data provision and</p>

	Chapter	Comment
	<p>Would giving service providers the option between either a TFP based methodology and a building block methodology be appropriate? Would the option create any perverse incentives?</p> <p>What would be the likely participation by service providers under a TFP based methodology?</p>	<p>management.</p> <p>Giving businesses the opportunity to opt into TFP would be appropriate as SP AusNet considers that setting prices with reference to industry averages mirrors the operation of a competitive market. Competitive markets evidently provide all participants with 'a reasonable opportunity to recover at least its efficient costs', even though market prices are not tailored to reflect the particular costs or productivity of each firm. This option does not create a perverse incentive as long as both approaches provided under the Rules are consistent with the pricing and revenue principles in the NEL.</p> <p>SP AusNet is willing to participate in consideration of TFP options via the AEMC review with the objective of identifying whether a TFP regime could be supported by the business. The key features on which such a scheme would be based are discussed in Section 4 of the main submission.</p>
	Implementation and transition	
33-	What is the required level of specification on a TFP based methodology that needs to be included in the Rules?	<p>Rules should not 'hard-wire' the detailed mechanics of how the TFP approach should operate. Rather, the Rules should balance the conflicting objectives of:</p> <ul style="list-style-type: none"> • providing sufficient flexibility on the detailed design issues (including, appropriate use of data; transitional issues; and S-factor arrangements) to ensure that company-specific and jurisdictional issues are addressed appropriately on case-by-case basis; and • providing DNSPs with sufficient regulatory certainty regarding the AER's application of the TFP approach, so that DNSPs can invest confidently in their networks. <p>In this respect SP AusNet considers key features of a TFP regime (such as regulatory periods and off-ramp mechanisms) should reside in Rules, while areas of regulatory application such as data provisions details; transitional issues; and incentive schemes should be allowed to evolve with regulatory experience.</p>
34	What are the criteria for assessing whether a TFP based methodology should be applied?	See section 5 for criteria for discussion on assessment of potential application of TFP.
35-	If a TFP based methodology was to be introduced, what would be the appropriate timing for its introduction? Should implementation	<p>Apart from achieving a model that is broadly supported, the timing for introducing TFP depends on a number of factors:</p> <ul style="list-style-type: none"> • significant consultation and analysis of the

	Chapter	Comment
	process include a trial period?	<p>indexing methodology and other implementation details;</p> <ul style="list-style-type: none"> • the quality of benchmarking data and information available; • how quickly the AER can establish appropriate information collection processes; • how long it would take to develop an agreed methodology for generating a TFP growth estimate and determining the 'X' factor; and • which businesses are interested or would be viable for TFP and providing them with an appropriate amount of time to prepare for a TFP-based review. <p>SP AusNet would expect that at least two years following the conclusion of this review would be required to allow for any introduction of TFP as an alternative approach to regulation.</p> <p>A trial period may be a good idea to test the effectiveness of the regime. As a transitional measure, benchmark information could be used to inform regulatory determinations as long as its development and application is transparent. This would help the AER build historical data for benchmarking and provide a basis for any adoption of a TFP approach if it becomes beneficial.</p>