TFP Presentation Notes

1 Rule change

- Lodged rule change proposal ~ May 2009
- Initiation of a TFP rule change pursuant to schedule 1 of the NEL
    - Explicitly authorises the making of rules for TFP, establishing TFP approach is explicitly recognised as an approach compatible with the NEL objective & pricing principles.

2 DPI's objectives:

- Ensure efficiency of monopoly distribution industry
- Propagate efficiency benefits across the State
- Ensure that the benefits of efficiency are returned to the community, through lower energy costs / higher economic productivity.
- Be a leader in technology, and in the national reform agenda
- Minimise the cost of doing all of this

3 Economic regulation

- Victoria took the lead in establishing independent regulation of networks in the 1990s.
- Victoria is taking the lead in smart metering, which should lead to
    - more efficient use of energy among energy users; and
    - better information for network businesses, opening up a range of opportunities for greater efficiency.
- Took the lead, indeed, in TFP; through ESC work on establishing a TFP indicator for Victorian DBs.

4 Rationales for TFP

4.1 Building Blocks is costly

- Large intrusive price determinations every 5 years
- Considerable cost to the community
- Considerable informational asymmetry between DBs and regulators
- Approach remains closely tied to cost-of-service practice, limiting incentive power
- Concern that with large increases in expenditure approved in jurisdictions recently that the info asymmetry is not improving.

4.2 Complexity of regulation

- The building block approach now embodied in the national framework is complex, with EBSS, S-factors, benchmarking data, reopeners, pass-throughs and much else.

- Although much development in the BB approach has been sophisticated and has increased the efficacy of regulation,
- Need to step back and and consider whether look at whether increasing complexity could be scaled back in light of new approaches in new circumstances.
- The fact that Victoria's distribution industry has now been through three consecutive independent regulatory pricing reviews means that the industry can be said to have reached a stable regulatory state where TFP may be tried.

4.3 Complexity of policy

- On the same theme, there is increasing policy complexity in energy technology, especially in light of the need to transition to a low carbon, high efficiency sector in order to adjust to carbon constraints.
- To push forward this agenda, government has introduced numerous policies, including:
    - Smart meter rollout
    - VEET
    - Feed-in-tariffs
    - Initiatives in building energy efficiency
- Policies aimed at energy efficiency and end-user/demand-side engagement are essentially aimed at forcing some of what government thinks are areas of potential greater efficiency in the way customers use energy supplied from energy networks.
- However, it should be in businesses' best interests to pursue these kinds of innovations as part of their business strategies.
- To date, the degree of innovation shown by network businesses has not been encouraging, with the focus being on a continuation of past practice - building and replacing network infrastructure, and earning a return upon the resultant asset base.
- Not all the fault of businesses - 5-year determinations take away much of the benefit.
- There is a risk from government with stakeholders demanding evidence of progress in areas like distributed generation and smart grids. The risk is that these kinds of intrusive detailed policies will flourish in order to maintain the perception of action on clean technological innovation.
- Such policies come at a cost, much greater than had businesses pursued them as a business opportunity. Govt has much less knowledge of how to efficiently go about improving technology in energy networks.

  THEREFORE

- we see the need for a much greater incentive for dynamic efficiency improvements than that offered by the current BB model of regulation. This is where TFP comes in.

5 Concerns with AEMC approach

- Much of the AEMC review is good - appreciate the conclusion that TFP would contribute to the national energy objective and should be pursued.

5.1 DATA

- Disappointed that the AEMC has concluded that design of a TFP index needs to be restarted from scratch, resulting in 8-year delay.
- In our view, the Rules made by the AEMC should be neutral as to the index used, and allow for regulatory evolution to continue.
- When building blocks regulation was begun in mid-1990s, the quality of information was poor, but this was not a rationale to avoid the task. Regulator had discretion to improve the methodology as it gained experience and better data.
- Same should apply to TFP. Note that it is relatively costless to replace one TFP index with another once it becomes available.
- Difference between TFP indicators tiny, esp. compared to the effects of data decisions impacting the P0 level in determinations, or differences between different forecasts.
- Not acceptable to wait 8 years for perfection.
- PEG/ESC indicator based on international practice. Note that the PEG approach has been adopted after being publicly tested against alternatives in Ontario.

5.2 DESIGN

- Concerned that AEMC has not adequately distinguished between a transitional & end-game TFP regime.
- Victoria's rule change transitional - designed to minimise risks & establish TFP within the Rules and develop regulatory practice. Therefore compromised on many elements at the expense of incentive power.
- AEMC has picked up elements of this transitional approach but report bases assessment of the costs/benefits as if they are final elements.
- End-game TFP regime moves away from cost-of-service model entirely and has an ongoing TFP based price path with off-ramps, no more pricing determinations. This is where the true benefits lie.

6 Why it works

- TFP based regulation, in end-game, provides much greater incentive to dynamic efficiency.
- The incentive is industry wide, and no business can remain inert vs its industry peers.
- TFP is its own method of returning the benefits to the community. With recalcuation or rolling of TFP, the benefits of industry-wide efficiency go back without the regulator ‘taking the punchbowl away’.
- Reduces the costs of network development and micro-policy development.
- And thus meets our needs for Victorians.

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