Department of Primary Industries

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John Pierce
Chairman
Australian Energy Market Commission

Our Ref: PD/03/0165

Dear Mr Pierce,

Submission – Draft determination – Total Factor Productivity for Distribution Network Regulation

Thank you for the opportunity to be consulted regarding the Australian Energy Market Commission's draft determination on rules for Total Factor Productivity for Distribution Network Regulation. Please find attached a submission on behalf of the Department of Primary Industries Victoria. You may direct any enquiries regarding this submission to Raif Sarcich – A/ Director, National Energy Markets on (03) 9658 4160 or at raif.sarcich@dpi.vic.gov.au.

Yours sincerely

Mark Feather
A/ Executive Director
Energy Sector Development

State Government Victoria

Submission – Draft determination – Total Factor Productivity for Distribution Network Regulation

The Department of Primary Industries (DPI) thanks the Australian Energy Market Commission (AEMC) for the opportunity to comment on its draft determination. This submission provides input on the key questions to be answered by the AEMC at this stage in the rule making process, the key one being how best to fulfil the policy intent behind the heads of power that authorise the making of rules for Total Factor Productivity (TFP).

Context of the TFP rule change

In June 2008, the then Victorian Minister for Energy and Resources submitted a proposed rule change to the National Electricity Rules (NER) (the Victorian proposal) providing for a TFP based methodology for setting distribution standard control services.

The context of the 2008 rule change proposal was one of increasing concern that the "building blocks" method of regulatory price setting in the electricity distribution industry was losing its efficacy in setting efficient prices and incentives for the network sector.

Victoria at that time had taken steps to develop a TFP based regulatory methodology because of the Essential Services Commission (Victoria)'s concerns about whether the building blocks method of price setting could be held to be true incentive regulation in the longer term.

The need for stronger incentives on businesses to make efficient long term investments, avoid over-investment, and to reduce opportunities to exploit regulatory information asymmetries were considered important from 2001 to 2008. In 2011, it is fair to say, the importance of these things is even greater.

In the last few years, upward step changes in electricity distribution network tariffs have been approved by the Australian Energy Regulator (AER) in most States and Territories, and this has given rise to a great deal of public commentary and scrutiny of the reasons for these price rises. Concerns have been expressed[1] that the regulatory arrangements permit gold plating, overbuilding, inefficiency and inflated costs. The increases in distribution costs have been and are expected to continue to be the biggest contributor to electricity price rises.

At the same time, new network management technologies and techniques are emerging and being implemented around the world. Generally dubbed "smart grid" technologies, these promised increased efficiency in managing flows of energy within electricity distribution networks and could improve overall efficiency in physical assets, maintenance, staffing, and reliability and security. Distribution networks

[1] E.g. Garnaut Climate Change Review Update: Paper 8 – Transforming the Electricity Sector; and Independent Pricing and Regulatory Tribunal draft report: Changes in regulated electricity retail prices from 1 July 2011, April 2011.

should operate under an incentive regime to pick up these technologies wherever they are efficient, irrespective of their effect on the level of 'poles and wires' investment.

Benefits of implementing TFP

The implementation of a TFP approach in the near term through the implementation of a TFP methodology for price setting would assist in ensuring that distribution networks continuously improve efficiency levels in maintaining existing networks as well as pursue the most efficient means of adopting new technologies. The AEMC's analysis in its TFP Review states that:

> "We found that this use of a TFP methodology in setting the allowed revenue path has the potential to create stronger incentives for service providers to pursue cost efficiencies compared to the building block approach.
>
> [and]
>
> ...a TFP methodology could reduce the scope for the service provider to boost returns by exploiting its information advantage over the regulator, and has the potential for lower regulatory costs."[2]

This led the AEMC to conclude the following:

> Based on its assessment against the five key criteria the AEMC is of the view that inclusion of a TFP-based methodology for setting price or revenue paths would contribute to achieving the National Electricity Objective (NEO) and National Gas Objective (NGO).[3]

Although supportive of a TFP approach to network regulation, the AEMC concluded in its final report to the Review that, in light of the absence of a robust nationwide database of distributor cost inputs and outputs, the achievement of the NEO and NGO through a TFP methodology was best pursued in a staged process.

This would involve initial rules being made for the collection and analysis of supporting data, and rules for price setting based on this data being made at a later stage based on the assessment of the AER of that data set.

That is the conclusion of the AEMC regarding the case for a TFP regulatory regime that is consistent and nation-wide, and best meets the NEO and NGO in the long term. The merits of the AEMC's proposed approach will next be considered by the Standing Council on Energy and Resources (SCER) and a response made.

DPI position on the TFP rule change

The Department of Primary Industries (DPI) is disappointed that the AEMC has made the draft decision not to make rules for the implementation of a TFP methodology for

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[2] AEMC, Final Report - Review Into the Use of TFP for the Determination of Prices and Revenues, On the web, June 2011, p. i.
[3] ibid, p. 9.

price setting at this time. DPI considers that the staged approach proposed by the AEMC will unnecessarily delay the potential introduction of TFP, particularly in Victoria where we believe that sufficient data already exists to support the introduction of TFP.

In this respect, DPI would like to reiterate the points made in its 2010 submission[4] to the Review's preliminary findings. This submission put forward the following propositions:

- TFP is mandated by the National Electricity Law (NEL) and National Gas Law (NGL)
- Delay in use of TFP methodology is contrary to the NEO and NGO
- Items 26J and 42 allow for possible data issues
- Inadequacy of data has not prevented introduction of TFP in other jurisdictions
- There is already sufficient data for Victoria

AEMC obligations under the TFP rule change

The AEMC's key duty in undertaking this rule change is to make rules for the use of TFP, as reflected in the Schedules to the NEL and NGL respectively which nominate TFP as subject matter for rules to be made.[5] This is a policy decision that was made by the Ministerial Council on Energy in settling those laws. To decline to make rules for TFP is, in the Department's view, inconsistent with the policy decisions which inform the AEMC's rule making powers.

These schedules in turn make it clear that the AEMC has discretion to make rules which implement the use of TFP in various regulatory contexts, including in making pricing and access determinations, or as a tool to assist or analyse the application of the building blocks price setting methodology.

Options for implementation of the rule change

Turning then to the options for making rules, these are for the AEMC are to accept the proposed rule as put forward by Victoria as achieving the NEO, or to make a more preferred rule. A more preferred rule, in turn, might reflect a variant of the Victorian proposal, the AEMC's own proposed approach derived from its Review, or some other rule that best achieves the NEO in the shorter term pending consideration of SCER's response to the Review.

DPI submits that the Victorian proposal achieves the NEO, and does not consider that circumstances have changed to affect its view. Moreover, the Victorian proposed rule is not fundamentally incompatible with the AEMC's proposed national approach to TFP.

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[4] Victorian DPI. Submission to Review Into the Use of TFP for the Determination of Prices and Revenues - Preliminary Findings. On the web, March 2010.
[5] Items 26J, Schedule 1 NEL and 42, Schedule 1, NGL.

The nature of the Victorian TFP was of a "pilot scheme". Whereas a fully developed TFP based regulatory framework would, for reasons of equity and efficiency, subject all relevant distributors to a TFP based price path, the Victorian proposal allowed distributors to 'opt-in' to the TFP regime (cf. proposed clause 6.2.4A (a)). Furthermore, the Victorian proposal was made able to be restrictive regarding which businesses *may* be subject to a TFP based pricing determination (cf. proposed clause 6.2.4A (b)). Considerable discretion was also given to the AER to flexibly apply TFP based on its assessment of needs.

The AEMC's approach in its Review, on the other hand, is for rules for TFP to be implemented first to enable nation-wide data gathering, with a further set of rules to be made at a later stage to enable the regulation of both electricity and gas distribution services/reference tariffs via TFP.

DPI considers that there is no incompatibility with rules being made in the short term under the NER to allow TFP based on existing data to be piloted in practice in a jurisdiction where this is feasible, with other rules being made to collect and rectify nation-wide data and prepare the ground for a fully fledged TFP based regime in both electricity and gas. In fact, this should contribute to the achievement of the NEO by allowing regulatory competence to be built up in the application of TFP without exposing the whole industry to unexpected outcomes through a sudden and significant change in regulatory methodologies.

If, at a later stage, the AER considers - and SCER agrees (as proposed by the final report in the Review[6]) - that conditions are met for a wider application of TFP, then the AEMC may propose rules accordingly to the SCER which may modify the already-instituted rules for TFP appropriately. This is unlikely to cause undue disruption for businesses already subject to TFP-based regulation.

Conclusion

In summary, DPI submits that a pilot TFP scheme can achieve the NEO, that a pilot scheme is not incompatible with the AEMC's proposed approach, and that the Victorian proposal is in the nature of a pilot scheme and itself meets the NEO. Rules also should be made for TFP in order to meet the agreed policy reflected in item 26J of Schedule 1 of the NEL. Rules should therefore be made to reflect the Victorian proposal, with any adjustments as may be necessary to ensure its compatibility with the development of a fuller nation-wide TFP scheme in the future.

[6] AEMC 2011. pp. 11-12.