21 August 2008

Dr John Tamblyn
Chair
Australian Energy Market Commission
PO Box H166
AUSTRALIA SQUARE NSW 1216

Dear Dr Tamblyn

AEMC RULE CHANGE - TOTAL FACTOR PRODUCTIVITY FOR DISTRIBUTION NETWORK REGULATION

ENERGEX appreciates the opportunity to comment on the proposed rule change which would allow the use of the Total Factor Productivity (TFP) methodology as a regulatory economic methodology applicable by the Australian Energy Regulator (AER).

ENERGEX agrees with the Commission that the issues involved are complex and warrant the preparation of an Issues Paper, in addition to the normal consultation process, before making a draft rule determination.
While the proposed rule change appears superficially innocuous (as it offers some businesses a choice of how they will be regulated), ENERGEX is concerned that, if adopted, it will seriously undermine the current regulatory framework.

This is because COAG's original intention for the national reforms to energy markets and governance arrangements was to create national consistency. The COAG Communiqué from COAG's 2001 directed officials to address, as a priority policy issue:

> *the potential for harmonising regulatory arrangements, removing inconsistencies and integrating networks.*

In 2004, the Australian Energy Market Agreement was amended and the MCE Bulletin (Energy Market Reform Bulletin No. 64) explained the purpose of the amendments was (amongst other things) to:

> *Confirm that the national approach to energy access will be State and Territory certified regimes. This will achieve national consistency both within and between the gas and electricity access regimes with minimal variation.*

Ref: RS08-019

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However, the Victorian Government's proposed rule change will create (rather than remove) inconsistencies in regulatory arrangements in two dimensions:

- between electricity distribution network businesses – since it is expected that some, but not all, businesses will "opt-in" to a TFP approach to regulation, there will be inconsistent regulation across distribution networks; and

- between electricity and gas distribution network businesses – since the proposal will leave gas distribution network businesses continuing to be regulated under the building blocks approach.

Not only is the Victorian Government's proposed rule change inconsistent with the fundamental drivers of national reform, the application of a TFP approach to regulation represents a retrograde step from the regulatory improvements that have been made in Australia in recent years that have placed greater emphasis on ensuring that regulation does not have unintended impacts on investment incentives. This is confirmed by the difficulties experienced in New Zealand with incentivising new investment in a TFP environment[1].

Moreover, ENERGEX does not believe that the TFP approach will be a workable regulatory model until the following conceptual and practical measurement issues are adequately addressed:

- the appropriate measurement of capital including differences in capacity utilisation resulting from different investment and demand up-take cycles;
- the complexities of:
  - accounting for price change in inputs and having available appropriate deflators;
  - accounting for quality change in inputs;
  - accounting for quality change in outputs including through investments which improve network reliability and service quality;
- the definition and measurement of output - the New Zealand experience has shown that the definition and measurement of output is a far more complex issue[2] than acknowledged in the Victorian Government's proposed rule change with the potential to impact on both measured average productivity levels and relative productivity performance as the specific outputs included will favour some businesses over others (e.g. networks undergoing significant asset renewal/replacement programs would be disadvantaged);

- highly variable performance - many of the implicit assumptions underlying the use of historical, industry-wide TFP data appear incorrect. For example, it is far from clear that past TFP performance is a reasonable indicator of future performance as TFP performance from period to period tends to be highly variable and in most industries is highly heterogeneous across businesses;

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[1] See Hon L. Dalziel, Minister of Commerce and Hon D. Parker, Minister of Energy 2007, Regulatory Impact Statement: Review of Parts 4 and 4A of the Commerce Act, Prepared for the Cabinet Economic Development Committee, New Zealand, November. The document can be accessed at http://www.med.govt.nz/templates/MultipageDocumentTOC 32527.aspx. Alternatively, see the submissions to the review process made by businesses or business associations.

[2] Lawrence, D. and E. Diewert 2004, Measuring Output and Productivity in Electricity Networks, SSHRC Conference on Index Number Theory and the Measurement of Prices and Productivity, Vancouver 30 June – 3 July.

- susceptibility to forecasting error - there is no reason to believe that the errors in using historical TFP as an indicator of performance over the forthcoming regulatory period are less than the errors in forecasting expenditure and demand under the building block approach; and

- informational requirements - implementing a TFP approach requires consistent time series information that is not currently available for the majority of distributors.

Many of these issues are significant problems that may introduce significant errors into regulatory processes, and, of critical concern to ENERGEX, uncertainty into our investment decision making processes. ENERGEX intends to elaborate on these concerns in our response to the Issues Paper.

Should you have any queries in relation to the above please do not hesitate to contact me directly on (07) 3223 1703.

Yours sincerely

Kevin Kehl
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