Submission responding to the Brattle reports to the AEMC

Opening comments

APIA appreciates the Commission providing an opportunity for stakeholders to comment on the reports by the Brattle group on *PEG's Incentive Power and Regulatory Options in Victoria* and *Options for the Building-Blocks Framework*.

We note that this opportunity is not necessarily within the purview of the TFP Review, but has potential to assist the Commission in making decisions about the use of TFP. This is because the benefits of TFP must be weighed against the counterfactual. That counterfactual is the building blocks methodology as it is, but must also include potential improvements to the building blocks methodology and any other possible methodology.

In this respect we note that the TFP Rule change proposal by the Victorian Government was proposed without having considered the alternatives. In APIA's view it was "a solution look for a problem" without having properly identified the "problem" and gained consensus about the nature and size of the "problem".

APIA takes the opportunity to respond to the Brattle reports very seriously because, like the Commission, APIA believes that there is scope to improve economic regulation of energy infrastructure in Australia, in particular for pipelines. APIA wishes to contribute to a constructive conversation about the improvements that could be made and to seek to move away from the adversarial debates that have characterised reform processes in the past.

In this vein we see the need for a considered rather than reactive development of ideas. While we recognise that various parties will take differing - and often opposing - views, we also are of the view that more constructive debate and better levels of alignment are achievable. However, this will require both constructive contribution and a willingness to suspend judgements about any party's agenda and positioning. We encourage the Commission, policymakers and regulators to consider this possibility.

Comments on the Brattle Reports

Review of "Incentive Power and Regulatory Options for Victoria"

APIA has been impressed by the quality and rigour of the Brattle review of the PEG report on incentive power. Brattle has identified the very significant flaws in both the analytical method and in the reasoning developed by PEG. Brattle's commentary is consistent with the position that APIA presented to the Commission at its Forum in February 2009. That is, incentives for efficiency come from the existence of a price path, and that the method of arriving at the path does not influence its incentive power. Moreover, incentives are reduced by introduction of path resets and shortening of reset periods.

In the light of this straight forward analysis and conclusions, APIA is surprised by the Commission's unqualified conclusion about the relative incentive properties of TFP and building blocks in its Preliminary Findings Paper. The conclusion appears to APIA to be at odds with Brattle.

Options for Reforming the Building-Blocks Framework

This too is a useful paper which could be the basis for a discussion about how to improve the Building Blocks methodology. Brattle is comprehensive in addressing the range of variants and options that have developed in the application of the Building Blocks worldwide.

The paper emphasises the work of OFGEM in is RPI-X@20 Review, which is appropriate given the lead the UK has taken in the development of the Building Blocks and CPI-X price path incentive methodology for economic regulation. However, Brattle seems inclined to encourage adoption of approaches that reflect the UK legal context and the nature of the UK energy industry without considering whether these are readily transferable to an Australian context. APIA also notes a tendency to favour more interventionist approaches. APIA encourages the Commission to constantly return to the well accepted principle that regulatory intervention introduces its own inefficiencies and distortions and that such interventions should only occur where market failure is clearly demonstrated and substantial, and regulation can be shown to improve economic outcomes.

A significant proportion of the options considered by Brattle are in fact already part of, and addressed by, the NEL/NER and NGL/NGR. It would be helpful if Brattle had reviewed the application of these options in the Australian setting and their effectiveness. Without such analysis it is difficult to assess the extent to which a particular option could be adjusted or improved. Such analysis is likely to be of assistance to the Commission in the TFP review and any future Rule changes or other reviews it undertakes.

What stands out to APIA is the fact that Brattle makes no mention of the role of efficient costs and how the requirement that regulators allow only efficient costs creates many of the problems we find in the Building Blocks methodology. We note that in a similar way the Commission, in evaluating the issues around the Building Blocks methodology in its paper *Perspective on the building blocks methodology*, did not recognise that a majority – if not all - of problems attributed to Building Blocks relate to this requirement on the regulator.

APIA commends to the Commission a further consideration of the extent to which the problems associated with Building Blocks are in fact not problems with the methodology itself, but a product of the regulator being given the impossible task of determining if costs are efficient. APIA submits that, if this obligation were relaxed to something more readily attainable, many of the perceived problems of the Building Blocks would be ameliorated, and many of the issues of conflict between regulators and service providers would diminish considerably.

APIA's reasoning for this is summarised as follows:

- Efficient cost is a valuable economic construct, but it is a theoretical construct arising from the concept of perfect competition. Since perfect competition does not practically arise, and only effective competition occurs, varyingly, in reality, at best efficient costs can only be approximated in markets where there is highly effective competition. Where markets have lower levels of effectiveness in competition the level of approximation is greater.

- Neither the regulator nor the regulated service provider can know what the efficient level of cost is for a business. While a regulated service provider is likely to have a better idea, it does not know what represents the efficient level. This is especially so for long lived assets such as pipelines, because the effect of spending too little is not likely to be known for between 5 and 20 years.
- With current very high levels of information disclosure required by the AER under the NGL, the information asymmetry gap is much less significant than is alleged. And if the gap is as significant as is alleged, then there is even more reason why a regulator should not be required to determine the efficient level of costs, because the probability of error is very high. This is particularly true and evident for pipelines, where its major customers are larger and are well capable of determining reasonable levels of costs for pipeline services.

Suggested principles for further consideration

In the light of the above, APIA suggests the following as useful principles for further consideration by the Commission:

- A reasonable task for the regulator, in place of having to determine efficient costs, is to determine whether costs are demonstrably inefficient or demonstrably unreasonable. This can be determined with current benchmarking techniques as long as proper statistical rigour is applied.
- Often the best benchmark for an individual service provider's costs is today's actual costs.
- Since the best the service provider can do is be constantly exploring avenues to improve efficiency, an achievable task for the regulator is to determine incentive arrangements that will provide the economic drivers to constantly seek to improve efficiency.
- Cost cutting is not the same as efficiency improvement. Incentives must be balanced so as to avoid inefficient cost cutting and make room to avoid or correct for cost cutting overshoot.
- In respect of pipelines it is important to remember that opex represents 20-25% of total revenue and, because of the sunk nature of pipelines, options for improving efficiency are limited. This means that opex reductions and opportunities to achieve them will be limited and that opportunities for price reductions as a result of opex reductions are limited as a consequence.
- The majority of costs for a pipeline are associated with sunk capital. Moreover, unless a pipeline is going through major expansions, new capex represents a very small proportion of revenue requirement. For a pipeline with an 80 year economic life new capex is likely to be less than 1.25% of the RAB per year(?). This means that a 1.25% variation in capex will have an infinitesimal impact of revenue and prices. For example, say the regulator was to reduce the approved forecast capex in the price path for a five year period by 20%, this would represent a reduction in prices of 0.125%. As transportation costs are between 10% and 30% of delivered price this would represent a 0.06 – 0.17% reduction in delivered price – in a price inelastic market. However, a reduction of 20% may have the impact of reducing the longevity or reliability of a pipeline that is only

registered 5 to 20 years later. Consequently an excessive concern for precision about the efficient level of costs will not only be illusory, but may potentially be damaging to the long term interest of consumers.