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Dear John,

## **AEMC's Review of Total Factor Productivity: Preliminary Findings Paper**

### **1. Introduction and Overview**

SP AusNet welcomes this opportunity to comment on the Commission's Preliminary Findings Paper on TFP. The Commission's paper raises some important questions and challenges for the future direction of network regulation. The timely and effective conclusion of the Commission's review now requires an increased focus on how the TFP-based regulatory regime would work in practice. This submission focuses on those elements which require further careful consideration by the Commission prior to finalising stage 1 of the review.

SP AusNet is one of few Australian energy market participants with substantial network facilities in more than one energy sector category. The company owns the Victorian electricity transmission network, one of five electricity distribution businesses in Victoria, and one of three gas distribution businesses in Victoria. SP AusNet is therefore very well placed to comment on the relative merits of TFP-based regulation in the different energy network sectors.

SP AusNet supports the development of an alternative regulatory approach based on TFP for the gas and electricity distribution sectors. In particular, TFP-based regulation, if designed appropriately, can provide a genuine opportunity to deliver a lower cost regulatory regime, and drive network businesses to achieve further cost savings and service improvements. SP AusNet also notes the comments made by the Victorian Government's Department of Primary Industries at the Commission's public forum, that TFP-based regulation may facilitate the innovation that is required to deliver a low carbon economy.

In relation to electricity transmission, SP AusNet supports Grid Australia's submission and the views expressed by the Australian Pipeline Industry Association (APIA) at the Commission's public forum on 1 February 2010. TFP-based regulation cannot properly capture genuine differences in the levels of productivity of individual companies for a number of reasons. Firstly, transmission is highly capital intensive, with investment in large-scale long-lived assets occurring in lumpy increments. Secondly TNSPs are subject to different reliability standards and investment cycles. These characteristics can distort measures of productivity for extended periods. Furthermore, 'output' is notoriously difficult to define with respect to electricity transmission, and therefore it is very difficult to be confident that measures of productivity will reflect actual performance. Given these considerations and the inherent characteristics of the electricity transmission sector, application of TFP regulation would create significant uncertainty for the sector. SP AusNet therefore considers that it would be appropriate for the Commission to clarify now that TFP-based regulation should not apply to electricity transmission.

In light of the considerations set out above, SP AusNet also concurs with Grid Australia that it would be inappropriate to impose additional information requirements on electricity transmission companies to enable the introduction of TFP-based regulation. The costs of collecting, verifying and submitting such information would ultimately be borne by customers. Given that TFP-regulation is not suitable for application to the electricity transmission sector, the costs associated with collection of additional data to facilitate TFP measurement would exceed the benefits, contrary to the interests of consumers.

The success of TFP-based regulation will depend on its design. While the Commission's paper concludes that TFP-based regulation would promote the achievement of the National Gas Objective (NGO) and National Electricity Objective (NEO), the preferred TFP design described in the Preliminary Findings Paper suggests that the Commission is reluctant to develop a regulatory regime that is genuinely different to building block regulation. In particular, the proposal that individual firms' price levels under TFP-based regulation should be recalibrated every 5 years does not provide a genuine alternative to building block regulation.

SP AusNet recommends that a fully detailed TFP design proposal be decided and articulated before the Commission proceed to stage 2 of its review and develop draft Rules for TFP-based regulation. This is necessary to ensure that the resulting regime is thoroughly considered and its detailed design features assessed before it is permanently codified in the regulatory framework. In the absence of such careful consideration, the Commission may develop TFP-based regulation that is practically redundant because it lacks the support of the regulated businesses. Further, any changes made to the rules to facilitate TFP should not effect changes to the building block regime.

The remainder of this submission discusses those matters where SP AusNet's views differ from those of the Commission. In particular, Section 2 comments on the Commission's proposed TFP design; and Section 3 discusses a number of TFP implementation issues.

## **2. Regulatory principles and TFP design**

### **2.1 Overview**

In terms of broad regulatory design principles, SP AusNet considers that the Rules should not 'hard-wire' the detailed mechanics of how the TFP approach should operate. Rather, the Rules should balance the conflicting objectives of:

- 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.

In terms of the more detailed TFP design features addressed in the Commission's paper, SP AusNet considers that:

- The minimum regulatory period should be longer than 5 years, and should be combined with off-ramps to ensure that prices and costs do not become materially misaligned;
- It is possible, and may be desirable, for an efficiency carry over mechanism (ECM) to operate in combination with TFP-based regulation;
- It is not possible to be definitive at this time regarding the question of whether service providers would face a higher cost of capital under a TFP regime compared to a building block model. The AER should maintain an open mind on this question; and
- The existing building block arrangements for depreciation are appropriate and should not be revised in tandem with the introduction of TFP-based regulation.

Each of these matters is addressed in turn below.

### **2.2 Length of regulatory period; price resetting and off-ramps**

TFP-based regulation is most suited to an industry that operates in a relatively 'steady state.' As noted above, TFP-based regulation should not be applied to the transmission sector, given its particular characteristics in terms of capital intensity, investment profile and outputs.

In some circumstances, the application of TFP-based regulation may also be problematic for some distribution businesses. TFP-based regulation is unlikely to accommodate step changes in capital or operating expenditure. Given the likelihood of such issues arising, TFP-based regulation should be sufficiently flexible to accommodate significant step-

changes in costs. The Commission's paper discusses various 'safeguard mechanisms' to address these risks<sup>1</sup>:

- off ramps, which would trigger an initial price cap reset if returns fall outside a pre-defined band;
- a capital module, which would permit the TFP price cap to be adjusted upwards if the service provider incurs increases in capital expenditure;
- a mechanism to allow capital expenditure overruns to be rolled into the RAB at the subsequent price reset; and
- an adjustment factor to the TFP growth index that is specific to each service provider.

SP AusNet agrees with the Commission that these types of safeguard mechanisms should be designed to share risk appropriately between network service providers and customers. SP AusNet also concurs with the Commission that there is a natural tension between these safeguard mechanisms and the power of the incentive regime:

"Whether such safeguard mechanisms weaken the incentive to control costs would depend on how the mechanisms would be designed. The key issue is striking the balance between allowing the service provider the ability to recover efficient costs and maintaining the efficiency incentives on service providers."

In addition to managing the risk of unexpected changes in costs, off-ramps could be used more broadly in a TFP-regime to strengthen the incentives to deliver efficiency improvements. In particular, as noted by the Expert Panel, off-ramps have an important role to play in allowing longer regulatory periods<sup>2</sup>:

"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."

In contrast to the Expert Panel's comments, however, the Commission suggests that TFP-based regulation is less conducive to a longer regulatory period than the building block regime:

"Having regular price determinations is a form of insurance for both the regulator and service provider. Although a regulatory period of longer than five years could be applied under either a TFP methodology or the building block approach, a longer regulatory period would be less likely to be practical under a TFP methodology than under the building block approach. This is because there would be a greater risk under a TFP methodology that the service provider would end up with prices significantly below costs. We also note that the application of a TFP methodology in overseas jurisdictions has not led to longer regulatory periods."

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<sup>1</sup> AEMC, *Review into the use of total factor productivity for the determination of prices and revenues: Preliminary Findings*, 17 December 2009, pages 42-44.

<sup>2</sup> Expert Panel on Energy Access Pricing, *Report to the Ministerial Council on Energy*, 2006, page 109.

One way to manage the risks associated with a longer regulatory period would be to employ safeguard mechanisms such as off ramps. The inclusion of such mechanisms may support longer regulatory periods, however they can affect the incentive properties of a TFP methodology. Hence, there is we see no reason why using a TFP methodology, instead of the building block approach, would automatically lead to longer regulatory periods.” (AEMC, page 26)

The Commission proposes that TFP regulation would be subject to 5 yearly price determinations to align prices and costs. This compromises one of the foundation principles of TFP, that is, that prices are de-linked from a firm’s actual costs. This de-linking means that industry-wide productivity drives improvements in output and cost management, as it would in a competitive sector. The AEMC’s approach of periodically aligning prices and costs naturally requires a review to determine the company’s efficient costs. At the recent TFP public forum the AEMC indicated that this review process could be confined to a ‘partial reset’ using a single year’s costs, rather than undertaking a detailed building block review. However, in practice, any consideration of ‘efficient costs’ is almost certain to lead to a detailed examination of actual and forecast firm-specific costs over a number of years.

The combination of an assessment as to “efficient costs” and automatic 5 yearly reviews will deliver outcomes and incentives that closely resemble building block regulation. SP AusNet cautions against the Commission’s approach because it fails to provide a genuine alternative to building block regulation and is likely to lead to an increase in regulatory costs.

In contrast to the Commission’s approach, SP AusNet agrees with the Expert Panel’s comments, noted above, that the potential for a longer regulatory period is an important feature of TFP-based regulation. In SP AusNet’s view, the power of the incentives under a TFP-regime would be greatly improved if longer (or indefinite) regulatory periods were adopted. SP AusNet considers that the length of the regulatory period should be at least 10 years, and possibly longer. The risks associated with the adoption of a materially longer regulatory period could be managed through the careful design of off-ramps that provide safeguards against under-recovery of costs (a concern cited by the Commission, as noted above), whilst also providing a mechanism for sharing benefits between the company and its customers.

A further concern is that the Commission’s proposed design of off-ramps would only address a breakdown in the relationship between output changes and input changes:

“Importantly such safeguards should not provide any protection against volume risk. Off ramps would only be needed to address any breakdown in the relationship between output changes and input changes. Whether there would be an unexpected shift in outputs would not, by itself, be relevant to the question of whether a TFP methodology would provide the opportunity for service providers to recover efficient costs.” (AEMC, pages 43 and 44)

In response to the Commission’s views, SP AusNet notes that in practice, volume risk is likely to have a direct bearing on a service provider’s ability to recover efficient costs. Moreover, it is not clear why or how the Commission intends to identify ‘a breakdown in the relationship between output changes and input changes’ or why it is necessary to exclude the impact of volume risk on cost recovery.

From the service providers’ perspective, the key question is whether the regulatory regime provides a reasonable opportunity to recover at least efficient costs (in

accordance with the revenue and pricing principles set out in the NEL and NGL). An off-ramp provides a mechanism for risk-sharing in circumstances where returns are materially above or below the cost of capital. In this context, a service provider might legitimately regard the reasons for significant excursions from the cost of capital as irrelevant if the company is consistently failing to recover its efficient costs.

The Commission's proposed approach relies on the regular application of the building block method to provide insurance against a material divergence between costs and prices. In contrast, SP AusNet's view is that more broadly defined off-ramps could enable TFP-based regulation to employ longer regulatory periods whilst also providing an effective remedy in the event that a material and sustained divergence between costs and revenues arises. Appropriately designed off ramps within a TFP regime would provide a genuine alternative to building block regulation, thereby also providing scope for delivering better outcomes for customers and lower regulatory costs.

### **2.3 Efficiency carry over mechanism**

The Commission concludes that TFP-based regulation could not employ an efficiency carry over mechanism (ECM):

"It would not be possible to adapt an ECM for inclusion into a TFP methodology. The exclusion of an ECM in a TFP methodology could weaken the efficiency incentive for recurring operating expenditure. However, this needs to be balanced against a TFP methodology's positive effect on how the regulator sets efficiency targets going forward." AEMC, page 24

However, the Commission's conclusion that it would not be possible to adapt an ECM for inclusion into a TFP methodology is not supported by the discussion in section 3.1.4 on page 29 of the Preliminary Findings Paper, which comments that:

"It would be difficult to apply such a [ECM] scheme under a TFP methodology given the absence of annual forecast of expenditure. We have considered possible options to adapt an ECM into a TFP methodology but found that there would be negative effects and concluded that they should not be applied."

It is a design choice whether TFP-based regulation includes an ECM, similar to the Commission's choice that TFP-based regulation should be augmented by a service target performance incentive scheme. This design choice should be informed by the incentive properties of the TFP-based regime (which will depend on the length of the regulatory period; the definition of off-ramps; and any re-setting of prices periodically to reflect costs).

It is incorrect for the Commission to conclude that it would not be possible to include an ECM as part of the TFP-based regime. SP AusNet considers that in a regime which includes short regulatory periods and regular price resets back to actual costs, incentives to deliver savings will certainly weaken towards the end of the period and an ECM would be necessary to balance this. The questions around how an ECM would work in a TFP context may be challenging to resolve but they warrant thought without being unduly dismissed. Given that the Regulator would presumably hold detailed and useful data on the actual operating costs of an individual firm for P<sub>0</sub>-setting purposes, it would be possible to use this to derive and set benchmarks for an ECM.

## 2.4 Cost of capital

The Commission argues that the cost of capital under a TFP-based methodology will be unchanged from a building block approach:

“Uncertainty about future regulatory decisions and commitments can lead to higher financing costs for service providers. This issue of regulatory commitment arises under the building block approach because of the timing mismatch between the five yearly price setting cycle and the timeframe for financing regulated service providers. Uncertainty in the financial markets about future price decisions and the allowed WACC tends to increase the regulatory risk premium in the cost of capital.

In principle, there would be no reason why a TFP methodology could not provide similar levels of certainty for investors compared to the building block approach. There would be sufficient prescription in the NER and NGR on the application of the methodology. Capital expenditure would be treated the same in the roll-forward methodology that would apply at each price reset determination. Also, it could be argued that the issue of regulatory commitment may diminish if a TFP methodology results in less subjective decisions for the regulator.” AEMC, page 46

SP AusNet considers that it is not possible to be definitive at this time regarding the question of whether service providers would face a higher cost of capital under a TFP regime compared to a building block model. For instance, more detailed information is required on how the TFP index would be calculated before such an assessment can be made.

SP AusNet agrees with the Commission’s observation (on page 44 of the Preliminary Findings Paper) that the revenue and pricing principles of the NGL and NEL require that:

“If under a TFP methodology it became more costly to finance investment, then there should be a corresponding increase in the allowed benchmark weighted average cost of capital (WACC).”

It would be our expectation that any increase in the cost of financing under a TFP model would be more than offset by improvements in the total factor productivity of the regulated businesses over the longer term, thus delivering longer term benefits to consumers (consistent with the NEO and NGO). On this basis, the AEMC should maintain an open mind as to whether the cost of capital faced by a business would be higher under a TFP methodology compared to the building block methodology.

SP AusNet questions the AEMC’s observation that capital expenditure would be rolled into the asset base at each price reset determination, and the inference that this will provide certainty to businesses under a TFP regime. As noted above, there is a need for more detailed information on how the TFP method is to be applied, but at this stage, SP AusNet understands that the certainty of capital expenditure roll-in would be available only under the building blocks method. Given the AEMC’s proposal to restrict businesses from electing to move back to a building block regime from a TFP regime (see section 3.6 below), the certainty provided by capital expenditure roll-in would be of no value to a business under the TFP model.

In reality, the initial novelty of TFP-based regulation may, unavoidably lead to an increase in investors’ perceptions of risk. The AER notes, correctly, on page 44 that:

“The cost of capital facing service providers depends on a number of factors, including investors’ perception of the risks facing the service provider and the certainty provided on the treatment of expenditure.”

These considerations reinforce the need for the AEMC to keep an open mind on the question of the impact of the introduction of TFP regulation on the cost of capital. In particular, it is important to recognise that service providers will be very reluctant to adopt a TFP regime if it is perceived to be more risky (initially at least) and there is inadequate compensation for that risk, or if the option of reverting back to the lower risk, building block regime is not available.

## **2.5 Depreciation**

The AEMC comments that the approach to depreciation could distort measures of TFP, and therefore a consistent method should be adopted across service providers:

“The solution to this issue [of accurately measuring TFP growth] is to require service providers to select depreciation profiles that are more consistent with the service potential profile of assets – and which do not involve front end loading – upon their move to a TFP methodology. That is, from the start of a TFP regulatory period, the remaining depreciation profile should more closely reflect the service potential profile rather than continuing the previous profile established under the building block approach, particularly if the latter has been front-end loaded.” (AEMC, page 78)

If service providers are able to move from a TFP methodology to the building block approach, then a related issue is what happens to depreciation? It would be preferable to require service providers continue with the depreciation approach set under a TFP methodology. Being able to switch between depreciation rates may provide circumstances where unnecessary volatility in prices results.” (AEMC, page 78)

The Commission’s paper canvasses at least two alternative approaches to measuring capital inputs. This indicates that further detailed development of the design of the TFP method is required before firm views can be reached on the approach to depreciation. That said, SP AusNet agrees with the Commission that the accurate measurement of capital-related costs is a pre-requisite for ensuring the accuracy of the TFP calculation, especially given the capital-intensive nature of electricity and gas networks.

However, SP AusNet disagrees with the suggestion that service providers who move from a TFP methodology to the building block approach should be required to continue to apply the same depreciation approach they used under the TFP methodology. The Commission notes (on page 78) that:

“Under the building block approach the regulatory depreciation schedules used for a service provider’s assets must meet the fundamental requirements of providing a return of capital over the life of the asset and providing it only once. The NER also reflects the economic principle of ensuring depreciation rates reflect actual asset lives to the maximum extent possible. However in practice, service providers have been given some discretion regarding asset depreciation schedules.”

SP AusNet is not aware of any evidence of “unnecessary volatility in prices” under the present building block regime, which the Commission correctly acknowledges has afforded service providers some discretion regarding the determination of depreciation schedules. Moreover, there is no reason to expect that switching between TFP and building block regulation would lead to volatile pricing outcomes, even if different



approaches to measuring depreciation were adopted. It is possible for any potential pricing impact resulting from a change in approach to be smoothed over a certain period. On this basis, SP AusNet does not consider that it is necessary to make changes to the current rules to further constrain the rules applying to the determination of depreciation under the building block approach. In a similar vein, SP AusNet also considers that it would be both inappropriate and unnecessary for any new depreciation rules developed as part of the TFP regime to be applied to the building block regime.

### **3. Practical implementation issues**

#### **3.1 Overview**

The Commission's paper raises a number of practical implementation issues, which leads the Commission to conclude (amongst other things) that:

- Service providers should be able to choose to opt into a TFP methodology but any subsequent opt out should be constrained; and
- It is not appropriate to implement a TFP methodology in the short term as the available data is not sufficiently robust or consistent.

In relation to both of these points, SP AusNet's view is that:

- TFP-based and building block regulation should be genuine and effective alternative forms of regulation. As such, there is no basis to restrict a distributor's ability to choose between the alternative regulatory regimes.
- It is not appropriate to delay the introduction of TFP-based regulation for eight years while new data is collected. Existing historic information could be 'cleaned' to ensure that consistent definitions of costs are employed, and could also be augmented by additional historic information (for example, physical asset quantities) where necessary.

These points are discussed in further detail below.

#### **3.2 Arrangements for reverting to the building block regime**

As noted above, the Commission has concluded that service providers should be constrained in their ability to revert to building block regulation:

"We suggest that the ability to opt out should be limited to exceptional circumstances where there would be a risk that the service provider would not have the opportunity to recover efficient costs. This should be determined by the AER. That is, the option to return to the building block approach should only be a part of the 'insurance mechanism' process and not a part of routine regulatory processes." AEMC, page 33

The Commission's position is based on concerns that distributors will defer capital expenditure in a TFP regime and then revert to a building block regime to recover the increased future capital expenditure requirements. In effect, the Commission postulates that network service providers will exploit the choice of regulatory regimes by under-investing in a TFP-based regime, and then reverting to building block regulation. Conversely, it could be argued that network service providers may be incentivised to

over-invest under building block regulation (to obtain a low rate of measured productivity) and then adopt TFP-based regulation.

These concerns appear to ignore the fact that the building block regime already includes checks and balances to deter businesses from deliberately under-investing. In particular, the capital expenditure criteria in the Rules allow the regulator to assess whether the forecast expenditure reasonably reflects the efficient costs that would be incurred by a prudent operator. A finding by the regulator that the firm has engaged in inefficient investment deferral would be relevant to the regulator's assessment of the capital expenditure forecast. In addition, the on-going application of a service target performance incentive scheme would protect against the uneconomic deferral of capital expenditure under either of the two regulatory models.

It is also important to note that the Commission's proposed solution to the gaming issue is to constrain the return to building block regulation to "exceptional circumstances where there would be a risk that the service provider would not have the opportunity to recover efficient costs." This proposed solution would provide the AER with significant discretion, and would make the adoption of TFP-based regulation (a new and untested regulatory approach in Australia) too risky from the service provider's perspective. In any event, it is not reasonable to deny a service provider the revenue that would be attributed to it under a building block regime. Such an approach would be inconsistent with the NEO and NGO. Placing a constraint on the service provider's ability to revert to building block regulation will simply diminish the prospects of a service provider electing to adopt TFP.

### **3.3 TFP information requirements and the case for reforming the building block regime**

The Commission makes the following observations regarding the availability and use of data in a TFP regime:

- It will take at least eight years, being one business cycle, before data is sufficient to permit a TFP methodology;
- The timeframe for service providers to recover at least their efficient costs (in accordance with the National Electricity Law) should be the same as the time period of historical data for calculating the TFP index; and
- A better, more consistent data-set should be specified to address inadequacies in the existing report regime and to facilitate TFP-based regulation.

In particular, the Commission's paper sets out the following views:

"We advocate that at least eight years of historical data be used to set the TFP growth rate for determining the X factor in order to smooth out the effects of business cycles. As under a TFP methodology it would be assumed that the historical productivity growth reflects the long term trend in productivity. This is the timeframe which the opportunity for service providers to recover efficient costs assessed. If ten years of historical data were used then, as long as the productivity growth trend remains, service providers would have an opportunity to recover efficient costs over the next ten years." (AEMC, page 39)

"A TFP methodology requires reliable and robust data from service providers. However, the existing data are not consistent, reliable nor robust. For a TFP methodology to be available to service providers, a data-set must be created. The AER and service providers must work

together in accordance with the NER and NGR to establish a workable regulatory reporting regime with the aim of commencing data collection as soon as practicable. Not only will this aid in the development of a TFP methodology, it will provide relevant information to the regulator under the building block approach, address information asymmetry concerns and provide users with greater comfort that regulated prices reflect efficient costs.” (AEMC, page 47)

As TFP-based regulation is essentially a benchmarking approach, SP AusNet agrees with the Commission that rigorous data requirements must be met in order to ensure consistency and to avoid distortions. SP AusNet therefore agrees with the Commission that a TFP methodology requires more reliable and robust data from service providers. In addition, TFP measures can be distorted by business cycle effects, and therefore issues arise regarding the appropriate measurement timeframes.

However, SP AusNet does not share the Commission’s view that it is necessary to delay the introduction of TFP for 8 years while the required data is collected. Historic data is available from network companies in addition to the information that has been reported to jurisdictional regulators over many years. Whilst existing data may not be ideal for the purposes of TFP-based regulation, reported data can be ‘cleaned’ to ensure acceptable consistency in definitions, and it may be augmented by additional historic data recorded by network companies but not reported to the jurisdictional regulators. SP AusNet’s view is that it would be better to make use of imperfect historic data rather than discard it. In making this observation, SP AusNet is particularly conscious of the inexact nature of TFP-based regulation, both in terms of measuring historic productivity, and the potential disconnection between historic and future productivity. Any deficiencies in data quality must be viewed in this context.

Further, SP AusNet disagrees with the suggestion that the timeframe for measuring TFP should be consistent with the timeframe over which service providers recover their efficient costs. In particular, the Commission states that if ten years of historical data were used to set TFP, then service providers would have an opportunity to recover efficient costs over the next ten years. SP AusNet notes that such a principle is not consistent with the Commission’s view that the regulatory period for TFP should be no more than 5 years, at which time prices would be reset back to cost.

SP AusNet accepts that it is appropriate to adopt a relatively long time horizon for the purposes of setting an X factor, especially if this approach reduces the weighting given to recent periods of rapid productivity growth that cannot be sustained. However, this does not imply that a similarly long time period should apply to the principle of cost recovery. The Commission’s approach implies that a network service provider should expect TFP-based regulation to provide expected returns which are lower than the cost of capital, for part or all of a regulatory period. This outcome would be inconsistent with a reasonable interpretation of the NEL and NGL. Moreover, very few, if any, service providers would elect to adopt TFP-based regulation if the expected return was below the cost of capital for any appreciable period.

SP AusNet also questions the assumption in the Preliminary Findings Paper that the current regulatory reporting is inadequate or that information asymmetry is a serious concern. The NGL and NEL and the respective rules provide the AER with wide-ranging powers to gather the information that it requires to conduct a building block review. Moreover, a detailed examination of the rules relating to building block regulation has only been completed comparatively recently. The design of the building block regime has

sought to balance carefully the roles and responsibilities of the AER and the network service providers. There is no evidence to support the stated concerns regarding the building block approach and the need for additional information.

SP AusNet notes that the Commission has obtained a report from the Brattle Group, which examines options for reforming the building block approach. The Commission explains the rationale for this report is as follows:

“It will take at least eight years before data is sufficient to permit a TFP methodology. In the meantime, significant changes in the industry may occur that could undermine the suitability of a TFP methodology. Also once a TFP methodology is implemented, it is possible that no service provider would decide to opt in. To date, most service providers have expressed reluctance to use a TFP methodology. In particular, the transmission service providers may remain under the building block approach.

Given this, it may be appropriate to consider whether there are amendments, or other alternatives, to the current form of the building block approach that could address its deficiencies and improve regulatory outcomes. This is part of the process of continual improvement and development of energy regulation. To provide information on other possible alternatives we are releasing a report prepared by The Brattle Group which outlines some of the amendments and alternatives that could be considered. We invite stakeholder views on whether such amendments should be explored further.” (AEMC, pages 86 and 87)

SP AusNet does not support any plans to initiate inquiries into the current building block regime now, on the assumption that TFP will not be in place for at least eight years. As already noted, the present building block regime was established in the NER and NGR just over three years ago, following extensive reviews by the MCE Expert Panel on Energy Access Pricing and the Commission itself. As such it is recommended this TFP review should focus on developing a workable and attractive TFP-based regulation, rather than considering issues relating to the newly codified building block arrangements.

We would be pleased to respond to any queries that you may have on our submission, and we look forward to participating constructively in the next stage of the Commission’s review.

Yours Sincerely



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