

Our Ref: M2008/450
Your Ref: EMO0006
Contact Officer: Mark McLeish
Contact Phone: (03) 9290 1834

3 March 2010

John
Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Dr Tamblyn,

Preliminary findings, review into the use of total factor productivity for the determination of prices and revenues, EMO0006

The AER appreciates the opportunity to comment on the AEMC's preliminary findings on the use of TFP for the determination of prices and revenues of gas and electricity network businesses. The AER recognises the extensive scope of the AEMC's review and the complexity of the issues that the AEMC has sought to resolve.

The AEMC has made the preliminary finding that applying a TFP methodology to determine regulated prices will contribute to the promotion of the NEO and NGO in the distribution sectors. However, due to a lack of a sufficiently robust or consistent data-set, the AEMC has not recommended that a TFP methodology for price/revenue determinations be introduced immediately. The AER agrees with the AEMC that the initial focus of TFP should be establishing a better, more consistent data-set.

However, the AER questions whether detailed rules should be drafted in stage 2 of the AEMC's review in the absence of data to fully test the robustness of any particular TFP methodology. In addition, the AEMC would also benefit from being able to have regard to such data in developing key elements of the design of a TFP methodology, such as safeguard mechanisms. This would enable the AEMC to test the extent to which its proposed safeguard mechanisms would under or over compensate service providers for business specific cost increases. On this point, the AER considers that

the AEMC should take care in designing safeguard mechanisms to ensure that they are not asymmetric to the detriment of consumers.

While the AEMC estimates that it may take a decade for a TFP methodology to become available for the determination of prices and revenues, the AER considers that the existing building block should be refined and improved well before that. As identified in the AEMC's preliminary findings report, one important element of improving the existing building block approach would involve expanding the AER's existing approach to information collection and reporting of the distribution sector.

Quite apart from its use in developing a TFP approach, the AER considers improving the consistency and robustness of information that it collects would assist in reducing information asymmetry, and would also enable the AER to further develop and improve the use of operating cost and capital expenditure benchmarking in its building block model determinations. In addition, an effective reporting regime would allow for regular public disclosure of information to better inform consumers and industry stakeholders of industry performance thereby strengthening the integrity of the regime.

The AER notes the AEMC's view that the AER has made limited progress in developing sector specific reporting regimes, recognising that service providers raised concerns about the purpose and scope of the information proposed to be sought in the AER's draft regulatory information order for electricity distribution. To address this, the AEMC has raised the possibility of amending the NGR and NER to provide greater clarification on maintaining a regulatory reporting regime for each sector that is relevant to a building block approach and a TFP methodology, including a timeframe for implementation, and specifying the minimum data to be included in the reporting regime.

The AER intends to further progress the development of information reporting requirements in 2010, and in the event that a TFP methodology becomes a regulatory option, the AER will incorporate the collection of data required for TFP as part of this process. The AER considers that further clarification in the NGR and NER of the need for a regulatory reporting regime to support the application of the current building block approach and a TFP methodology would put beyond doubt the need for the AER to collect the information for the performance or exercise of its functions and powers.

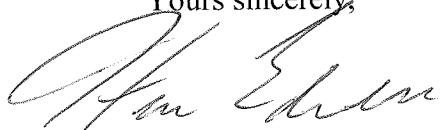
However, the AER does not consider that there is a need to prescribe a timeframe for the implementation of reporting requirements to be included in the NGR and NER. Similarly, it would be preferable for data requirements for a TFP methodology to be detailed in a regulatory information notice or order rather than included in the NER or NGR. Nevertheless, as noted above, a statement in the NER that TFP is intended to be a regulatory option would assist in the timely collection of relevant data.

In addition to enhancing, in the short term, the information reporting requirements for the existing building block approach, there would be merit in exploring options for improving the building block approach as presented in the Brattle Group report commissioned by the AEMC. The AER suggests this could be undertaken in stage 2 of the AEMC's review.

In particular, the AER notes that the Brattle Group report identifies the menu approach or, alternatively, the information quality incentive (IQI) applied by OFGEM as an option for reforming the existing building block approach. A menu approach would appear to provide stronger incentives on service providers to provide the AER with unbiased cost forecasts. The AER considers that the AEMC should conduct further work on how such an option would operate alongside the current building block approach specified in the NGL and NEL. Given the ten year timeframe for possible implementation of TFP, this would at least be an intermediate step to addressing, in the intervening period, some of the potential concerns that the AEMC has identified with the current form of the building block approach.

The AER will provide further input into the AEMC's review as the AEMC proceeds to developing its draft recommendations for the MCE. Should you wish to discuss this submission, please contact Chris Pattas on (03) 9290 1470, or alternatively Mark McLeish on (03) 9290 1834.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Steve Edwell', written in a cursive style.

Steve Edwell
Chairman
Australian Energy Regulator