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Australian Energy Market Commission  
AEMC Submissions  
PO Box A2449  
Sydney South NSW 1235

61 Mary Street  
Brisbane QLD 4000  
PO Box 15107  
City East QLD 4002  
Phone 07 3228 8222  
Fax 07 3228 8118  
Website [www.ergon.com.au](http://www.ergon.com.au)

By email: [submissions@aemc.gov.au](mailto:submissions@aemc.gov.au)

Dear Sir / Madam

## **Review into the use of Total Factor Productivity for the determination of prices and revenues**

Ergon Energy Corporation Ltd (Ergon Energy) welcomes the opportunity provided by the Australian Energy Market Commission to comment on its Framework and Issues Paper regarding the Review into the use of Total Factor Productivity (TFP) for the determination of prices and revenues.

This submission, which is available for publication, is made by Ergon Energy in its capacity as an electricity Distribution Network Service Provider in Queensland.

Ergon Energy strongly supports a review of the merits of adopting TFP as an alternative control setting method prior to the consideration of any specific rule change proposal. In its previous submission, however, Ergon Energy's preferred position was that a review should only occur after the new provisions of Chapter 6 of the National Electricity Rules (Rules) have been in operation for some time. This would provide industry and regulators an opportunity to "work through" the practical application of the Rules and gain an understanding of how a TFP would operate in this new framework.

Ergon Energy does not support the introduction of TFP as an alternative control setting method at this time. Ergon Energy's concerns with adopting TFP in the Rules are set out below.

### ***Achievement of Objectives and Revenue and Pricing Principles***

Ergon Energy is concerned that the "policy problem" that the introduction of TFP is attempting to "solve" has not been articulated.

Chapter 6 of the Rules was recently developed under a fully consultative approach and has only just commenced operation. As part of the consultation on the new provisions of Chapter 6, TFP was considered in detail as a possible control setting method by the Expert Panel appointed by the Ministerial Council on Energy (MCE). It was determined that specific Rules allowing TFP to be used as an alternative to the building block methodology not be included.

There is no compelling reason to amend the Rules to include TFP without the Rules having been used by the AER and demonstrated through that usage to be inadequate or unable to deliver on the objectives or intent of the Rules and the National Electricity Law (NEL).

Ergon Energy is also concerned that TFP may be contrary to the objectives of the NEL, in so far as it decouples firm specific costs and revenues over a regulatory control period. In particular, section 7A(2) of the NEL requires that a Distribution Network Service Provider (DNSP) should be provided with a “reasonable opportunity to recover at least the efficient costs the operator incurs in providing direct control network services...”. Providing DNSPs with this opportunity, and thereby giving them a level of revenue certainty, is a fundamental requirement for DNSPs to continue to invest in their networks.

### ***Timing of introducing TFP & compatibility with regulatory framework***

The Expert Panel appointed by the MCE to review Chapter 6 of the Rules, considered the introduction of TFP. The Expert Panel placed significant qualifiers on the future adoption of TFP as a control setting method, including:

- The businesses or industry being regulated are in a relatively steady state, i.e. a long term estimate of TFP represents a relatively good estimator of future cost and or demand changes; and
- It is adopted at times in an industry’s or business’s life cycle where its forward looking capital expenditure has a relatively smooth profile.

Ergon Energy does not consider that the industry is currently in a relatively steady state. The MCE is continuing its ongoing reform agenda towards developing a national regulatory framework. It is also anticipated that there will be further reforms arising from Government policies targeting climate change issues.

Further, Chapter 6 of the Rules has only just commenced operation and has introduced significant changes regarding how distribution services are regulated. Ergon Energy considers that the introduction of TFP should only be contemplated once Chapter 6 of the Rules has been in operation for some time (that is each service provider has had one full cycle of applying Chapter 6). This would provide industry and regulators an opportunity to “work through” the practical application of the new provisions and gain a better understanding of how a TFP control setting method would operate in this new framework.

In this context, Ergon Energy notes that TFP is likely to be impractical as a control setting method under the new provisions of Chapter 6 of the Rules because DNSPs will have different services included within their standard control services category. They will therefore also have different cost components. As a consequence, the information used in the calculation of both their “inputs” and “outputs” (i.e. productivity) for these services will not be comparable between DNSPs, and therefore not applicable to any DNSP under TFP.

Also as noted in previous submissions, Ergon Energy does not consider that the industry is at a point in its “life cycle” where forward-looking capital expenditure has a relatively smooth profile. Ergon Energy is currently experiencing significant load growth in its area which requires substantial investment in network infrastructure. Ergon Energy understands that high load growth is also a factor on other distribution networks.

### ***Comparability of businesses & design of TFP***

Ergon Energy considers that the lack of “comparability” between DNSPs is a significant barrier to the introduction of an accurate TFP measure. By way of example, Ergon Energy’s region covers more than one million square kilometres which is over 6 times the size of Victoria. Ergon Energy owns and operates a total line length of line 146,339 kilometres with



a customer density of 5.2 customers per kilometre of line (the lowest density of customers in the western world for 100,000 kilometres of line west of the Great Dividing Range).

A further issue is the adoption of measures that are appropriate for all businesses. Ergon Energy considers that the use of TFP for a DNSP is only feasible if the input and output measures are truly reflective of the provider's inputs and outputs.

As identified in the 11 February 2009 presentation by Denis Lawrence of Economic Insights, the network companies "are responsible for the providing the "the road" (i.e. system capacity) and keeping it in good condition, but has little, if any, control over the amount of "traffic" that goes down the road."

Ergon Energy is concerned that despite this view of the DNSP's output, the proposal for the use of TFP identified energy as an output. This output measure is not appropriate given the potential for a TFP factor to be significantly influenced by energy usage changes with no capital or operational cost changes (and by definition no productivity change) by the provider. Even the use of weightings of 20%, as suggested during the presentation, allows significant distortion of TFP with no change of inputs or activity by the DNSP.

By way of example, a major mine or mineral processing facility can change their energy usage from 1 shift to 3 shift operation with no change to the network infrastructure or operational costs for the DNSP, but purely responding to the commodity market prices. This could change total energy throughput for a DNSP's network by approximately 2% (in Ergon Energy's case) for a single major consumer and consequently the TFP could vary by 0.4%-2% depending on the weightings applied. This is a significant variance in TFP with no change to true productivity by the DNSP, but will potentially reflect positively or negatively in performance interpretation and consequently future revenue. For this reason Ergon Energy does not consider the use of TFP as a valid productivity measure while it includes energy as an output measure for a DNSP.

### ***Application of TFP***

If TFP is introduced into the Rules, Ergon Energy considers that its application should be strictly at the election of the DNSP.

Ergon Energy is also concerned that, even if it does not choose to apply TFP for itself, it (and other DNSPs) may be required to collect, maintain and provide information to the AER to aid its application of, or inform its calculation of, TFP for DNSPs which choose to be regulated under this approach. Ergon Energy believes that these information requirements would impose an unnecessary administrative burden on Ergon Energy (and other DNSPs). The impact of this draft Rule change proposal should therefore not be limited to DNSPs that may choose to apply TFP as the control setting method.

If you have any questions or require any further information on the matters raised please do not hesitate to contact me on (07) 3228 7711.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Tony Pfeiffer', with a long horizontal stroke extending to the right.

Tony Pfeiffer  
General Manager Regulatory Affairs

Telephone: 07 3228 7711  
Facsimile: 07 3228 8130  
Email: [tony.pfeiffer@ergon.com.au](mailto:tony.pfeiffer@ergon.com.au)