

22 August 2008

Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Dr Tamblyn

Total factor productivity for distribution network regulation Rule change proposal

Thank you for the opportunity to provide a submission on the Rule change proposed by the Victorian Minister for Energy and Resources to allow the Australian Energy Regulator (AER) to use Total Factor Productivity (TFP) as a methodology for regulating the revenues of distribution network service providers (DNSPs).

Integral Energy agrees that, in theory, TFP offers the potential for lighter handed regulation and greater efficiency outcomes for customers. However, it submits that the Rule change in its current form should be rejected because it fails to demonstrate that the proposed approach meets or is likely to meet the National Electricity Objective more efficiently than the current arrangements set out in the National Electricity Rules (Rules).

Central to the rationale for TFP is that historic conditions provide a sound indication of future expectations. The TFP approach is not, however, suited to periods where future expenditure is likely to increase beyond existing trends. Integral Energy submits that the upcoming environment is not a "steady state" period as evidenced by the current NSW DNSP regulatory submissions to the AER where material, non-linear increases in capital and operating expenditures have been foreshadowed. In such circumstances, it becomes hard to see how the use of TFP would satisfy the revenue and pricing principles that form the basis of regulation¹. The proposal itself provides no clear criterion for identifying what would constitute a change in expenditure profile sufficient to exclude the use of TFP.

This is because:

- while the current national regulatory framework developed by the Ministerial Council on Energy (MCE) is in its infancy, the CPI-X incentive based building block form of regulation on which it is based is well understood by stakeholders, having been applied

¹ National Electricity Law, s 7A

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consistently over the last ten years. Moving to a new form of regulation at this point needs to be treated with considerable caution; and

- the Rule change proposal, as put forward, provides very little information as to how such an approach would operate in practice. This makes it both impractical to assess the merits of the proposal and, if passed in its current form, would result in considerable risk to the regulated DNSP and its customers.

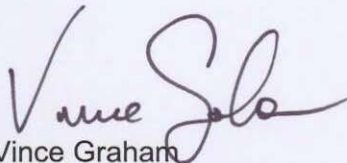
Integral Energy does not support the concept that including TFP as an *option* means that it is somehow free from being assessed on its own merits. The NEL is clear: the Rule change proposal must demonstrate that the proposal to include it as an option provides or is likely to provide a more efficient outcome than the status quo. It would not be acceptable, for example, to allow a DNSP to exercise an option if it were likely to generate less efficiencies - this would be a step backward for customers. The merits of any proposed TFP option would need to be more clearly shown.

A number of related issues are addressed in the attachment to this letter.

Given these concerns, Integral Energy welcomes the AEMC's plan to extend the consultation process with respect to the proposal. This should provide an opportunity for stakeholders to fully investigate whether those issues can be addressed in a way that demonstrates that the option to use TFP generates the required certainty for DNSPs and value for customers.

Should you wish to discuss any aspect of this submission, please contact Mike Martinson on (02) 9853 4375.

Yours sincerely



Vince Graham

Chief Executive Officer

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Attachment — TFP for distribution regulation Rule change proposal

Claimed benefits of the TFP approach

The Victorian Minister for Energy and Resources (the Minister) submits that the TFP approach offers a lighter-handed form of regulation, the benefits of which include:

- improved efficiency by reducing information asymmetries — the TFP approach removes reliance on a DNSP's forecast expenditures and instead uses "known and measurable" (historic) industry-wide information to set the future price path. The Minister claims this will reduce the risk of inappropriate windfall gains accruing to the DNSP; and
- reduced regulatory administration costs by allowing longer periods between regulatory resets — the TFP's "steady state" expenditure assumption would allow the AER to extend the regulatory period beyond the current standard of five years, thus reducing the administrative cost of regulation.

Issues

The current regulatory framework is reasonably well understood and efficient

To satisfy the Rule making test¹, the Minister's proposal must demonstrate that the proposed TFP approach generates or is likely to generate greater efficiencies than those obtained through use of the current regulatory model.

The current form of DNSP revenue regulation is reasonably well understood and operates effectively. It is an incentive based CPI-X building block approach that returns efficient costs while providing an incentive to businesses to improve those efficiencies further over time. Admittedly, the mechanism is not perfect in terms of ensuring complete efficiency. However, it is well understood, having been developed over a period of more than ten years and used in virtually every electricity regulatory revenue decision over that time. This certainty is important in providing an appropriate climate for investment in essential infrastructure, which is characterised by assets with lives spanning many decades.

In addition, the MCE and AER have recently introduced focussed incentive schemes to further minimise the current methodology's shortcomings. This includes the Service Target Performance Incentive Scheme (STPIS) and Efficiency Benefit Sharing Scheme (EBSS). As an example, the EBSS has been designed to ensure that efficiency cost savings are shared

¹ National Electricity Law (NEL), s 88.

with consumers while removing any incentive DNSPs may have to overstate expenditure forecasts.

These steps have been complemented by the revised AER review process introduced in the new Chapter 6 of the Rules. That process arguably now achieves greater regulatory scrutiny per dollar of regulator's administrative cost than before. The AER is now required to publish framework papers ahead of each reset and also specify in Regulatory Information Notices what information DNSPs must provide as part of their revenue proposal. The new framework appears to reduce both the information asymmetries and the risks associated with the regulatory process thereby ensuring more efficient outcomes for customers. Integral Energy submits that these arrangements should be given an opportunity to be tested through experience rather than complicating or substituting them and thereby introducing greater regulatory risk to the DNSPs and their customers.

Theoretical and practical issues

A well defined framework is vital to the success of any regulatory regime. Integral Energy submits that the Minister's proposal fails to set out a sufficiently clear and workable framework. The acceptance of the proposal in its present state of development would lead to increased regulatory uncertainty, a cost that would inevitably be borne by customers. While Integral Energy does not object in principle to the use of TFP as an option for DNSPs to exercise, it considers that the following issues would need to be addressed before such an approach could be successfully implemented. A number of examples of Integral Energy's concerns are described below.

Using historic and industry-wide information to generate a firm-specific efficiency driver

Central to the rationale for TFP is that historic conditions provide a sound indication of future expectations. The TFP approach is not, however, suited to periods where future expenditure is likely to increase beyond existing trends. Integral Energy submits that the upcoming environment is not a "steady state" period as evidenced by the current NSW DNSP regulatory submissions to the AER where material, non-linear increases in capital and operating expenditures have been foreshadowed. In such circumstances, it becomes hard to see how the use of TFP would satisfy the revenue and pricing principles that form the basis of regulation². The proposal itself provides no clear criterion for identifying what would constitute a change in expenditure profile sufficient to exclude the use of TFP.

The current CPI-X incentive based building block approach allows adjustment for firm specific cost drivers such as climate and network topology, as well as jurisdictionally specified service performance obligations. By contrast, the proposed TFP approach precludes consideration of such factors, relying almost exclusively on industry-wide benchmarks. The rationale for doing so is that firm-specific factors can distort appropriate

² National Electricity Law, s 7A.

efficiency targets. However, it should not be simply assumed that local variations represent inefficiencies. They may be the true, efficient cost of providing services in the local area. The application of an ill-suited industry benchmark, while it may offer short-term savings, is likely to deliver poor service outcomes for customers in the longer term. Caution should be exercised when considering adopting a less flexible approach.

Data comparability, transparency and costs

Building on this last point, the TFP approach is fundamentally dependent on the availability of high quality time-series data sets that can be used to accurately calculate industry-wide input/output trends. As such, data must be collected through a transparent process that ensures that the data is measurable, comparable and reliable.

This is complicated given the size and diverse structural, ownership and operating characteristics of Australian DNSPs. However, those problems would be magnified if the regulator were also to include international data in the set as proposed. Foreign markets are almost certain to have different economic drivers and conditions, something that would deeply complicate any comparison of labour and capital productivity rates. Making adjustments for the fact that foreign regimes have a number of “off ramps” would also appear to be problematic.

The use of inaccurate or inappropriate data would lead to the application of higher or lower efficiency drivers than would be the true efficiency driver for the individual firm. Integral Energy submits that the Rule change proposal has not addressed whether the risk of error caused by TFP data limitations, particularly if restricted to a small domestic data sample size, is less than the risks relative to using the current firm-specific CPI-X building block approach.

The regulator’s development and maintenance of a transparent and reliable data set will also be likely to incur ongoing administrative costs, regardless of the number of DNSPs that “opt in” to the TFP approach. This cost will ultimately be borne by customers, and as such, must be considered in the evaluation of the TFP approach. Even if TFP is used, the building block method would still be required to “reset” the TFP approach at the beginning of each regulatory period.

Regulatory risks

The matters raised above may be less problematic were the relevant methodologies set out in the Rules themselves. However, the Rule change proposal requires the AER to publish those methodologies in guidelines. It also provides that these guidelines would be non-binding. Integral Energy submits that this uncertainty would only contribute to the risk faced by DNSP stakeholders.

Related to this is a concern that the timeframes proposed for a DNSP to nominate the use of TFP, the AER to respond either affirmatively or negatively and then the DNSP to provide its

regulatory submission are unrealistic and may expose the DNSP to the risks of being judged as having provided a non-compliant revenue proposal.

These regulatory uncertainties combined with the risks arising from the use of low quality data raise a strong concern as to whether having fewer resets and longer regulatory periods is achievable in practice. The risks of deviating from the efficient price path are increased and the outcomes magnified over a longer period of time. Inevitably these risks must be passed on to customers or threaten the viability of service delivery and the willingness to invest.

Conflicting incentives to use TFP

There are other issues with the proposed “opt in” approach. A DNSP would only have an incentive to opt in to TFP regulation if it thought that it would be likely to make greater returns by doing so. However, the DNSP is also confronted with the prospect that the AER would only allow it to be so regulated if the AER thought it could be able to generate greater efficiencies than under the current incentive-based approach. On balance, the overall incentive to make use of the TFP option may be limited.

Loss of synergies from uniform pricing reset

Under this Rule change proposal it would become possible that DNSPs operating within the same jurisdiction are regulated using different methodologies over different regulatory control periods. If this were the case, the AER would lose the administrative cost synergy generated by performing the regulatory reset process at the same time for those DNSPs.

Making the case for TFP as an option

Finally, Integral Energy does not support the concept that including TFP as an *option* means that it is somehow free from being assessed on its own merits. The NEL is clear: the Rule change proposal must demonstrate that the proposal to include it as an option provides or is likely to provide a more efficient outcome than the status quo. It would not be acceptable, for example, to allow a DNSP to exercise an option if it were likely to generate less efficiencies — this would be a step backward for customers. The merits of any proposed TFP option would need to be more clearly shown.