

24 December 2010

Mr John Pierce
Chairman
Australian Energy Markets Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Pierce

AEMC Review into the use of Total Factor Productivity (TFP)

Integral Energy welcomes this opportunity to provide further input into the two year review program on TFP by the AEMC. While, acknowledging the significant investment of the AEMC and market participants to building a common understanding of TFP and its potential uses in regulation moving forward, Integral Energy believes that substantial matters remain unresolved, and will only become clearer over time with further public review and debate.

Experience with TFP Measures

In recent years Integral Energy has been involved in TFP activities with mixed results. However, the experience does provide Integral Energy with a greater understanding of the operation of TFP models with the outcomes, process and approach highlighting several issues which have been raised through the review to date.

One matter that is of critical concern is the potential for TFP methodologies to present a distorted perception of efficiency. The recent TFP exercises highlighted the magnitude by which renewal programs can distort the perceived efficiency of network businesses, particularly when combined with a model that exclusively uses chargeable units as the proxy for network "outputs". When comparative analysis was undertaken between using energy delivered and peak demand as the "output" of the network the outcomes were starkly different over a 10 year period. Indeed the choice of output was the determining factor between reporting a TFP improvement or not over the selected period.

It also became clear through this process that there are significant challenges in providing not only consistent data due to changes in accounting policies etc over time, but also in accurately separating out costs of new obligations or services. This is most challenging once a new obligation becomes ingrained in "business as usual" where it is not sensible to develop two ongoing capital and operating programs to merely track the impact of the changes.

Need for Rule change

Integral Energy is not yet convinced that a separate set of Rules to both empower the AER to collect the TFP data as well as specifying its coverage is the most appropriate or efficient approach to data collection to inform future TFP discussions.

Going further for you is what we do

As the Commission would be aware, the AER has quite broad information gathering powers under the NEL and NER that would allow it to request data relevant to TFP as part of the annual regulatory account details required of the regulated businesses annually. Moreover, the requirement to report two sets of annual financial information, most likely on similar but not precisely the same basis, would impose additional record keeping, audit and reporting costs for no discernable benefit. Indeed the “almost” duplication would likely reduce the understanding of the overall business outcomes and drivers in the pursuit of understanding minor definitional differences.

In light of the outcomes of this review to date, it is not apparent that there would be any grounds to consider the AER’s authority to gather information for TFP purposes to be constrained under the Rules. Moreover, Integral Energy would expect that the AER would follow its usual procedures and conduct an open and transparent public consultation process when developing any revised RIO to accommodate the collection of TFP data. This process would of course ensure that business concerns regarding the various definitions applied in different jurisdictions could be accommodated as well as ensuring that the Commission is able to provide advice to the AER on the information it believes should be reported to support future assessments of the role, if any, of TFP.

Inconsistency between allowed revenues and cost drivers

As discussed earlier, Integral Energy believes that a TFP approach that relies solely on chargeable units as the “output” of a network is unlikely to measure efficiency in undertaking the regulated network activities, but rather will merely be a measure of the average cost to serve. Integral Energy notes that while these two concepts may generally have a positive (linked) relationship; this is not always the case and failure to recognise this difference will lead to a misunderstanding of the true underlying efficiencies or otherwise of a network’s operations and activities.

Further, only including outputs based on those services upon which customers are billed (and their proportions) may have implications for the manner and services upon which networks set their charges within a TFP framework. Such changes would be logical to consider as a means to protect financial viability in light of the proposed disconnect between movements in cost drivers and movements in revenues.

While this may have some conceptual attractions for economists, a paradigm shift in network charges and structures, particularly at this time, would have challenges in gaining customer understanding and acceptance. As a secondary matter, it is not clear whether any progress to address the cost and revenue disconnect via changes in network pricing structures may have implications on the operation and nature of a TFP regime.

Abrogation of responsibility

The “way forward” contained in the Draft Report has the appearance of absolving the Commission of its responsibility to bring the TFP to its ultimate conclusion by granting the AER pseudo rule making powers in respect of the final form and application of any TFP model.

One of the key reforms underpinning the transition from the National Electricity Code to the NEL and NER was the separation of Rule making and enforcement powers. Maintaining clarity of this separation is critical for ensuring transparency and predictability in both the making and enforcement of the NER. As a consequence any

blurring of the lines between these two functions (perceived or otherwise) should be avoided to protect regulatory certainty and ensure clear accountability.

Should you have any questions in relation to this submission to your Draft Report please contact our Manager, Network Regulation, Mr Mike Martinson on (02) 9853 4375.

Yours sincerely

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

Scott Ryan
Acting Group General Manager
Network