Preliminary Findings: Economic Assessment

Review into the use of total factor productivity for the determination of prices and revenues

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Economic Assessment

- The economic assessment focuses on the efficiency properties of TFP compared to the building block approach:
  - a comparison of the methodologies in general
  - consideration of particular design features
  - consistency with giving service providers a reasonable opportunity to recover efficient costs

- For this assessment, the practical issues are taken as resolvable. That is,
  - that the necessary data-set will be available
  - calculation of a TFP index can be formed to accurately measure industry productivity

Efficiency properties of a TFP methodology (1)

- The key difference between TFP and the building block approach is the relationship between regulated revenues and productivity over time
  - TFP: revenues move in line with historic trend of industry productivity
  - building block: greater weight on forecast productivity for the service provider

- This could be characterised as:
  - TFP: service providers are benchmarked against industry performance
  - building block: service providers are benchmarked against their own past performance

Efficiency properties of a TFP methodology (2)

- This difference between TFP and the building block approach means there is a difference in the incentives for service providers to invest in activities that improve productivity over time.

- The incentive is stronger under a TFP methodology because:
  - a service provider retains the benefits gained from outperforming the industry average productivity growth for as long as it continues to outperform
  - below average performance will have a greater impact on a service provider's returns

- In contrast, under the building block approach, gains from outperforming own productivity forecasts are retained for five years.

- The stronger incentives for productivity improvements from TFP will ultimately lead to lower prices for regulated services across the industry.

Efficiency and design of a TFP methodology

- TFP is about dynamic efficiency over the long term:
  - free opt-in and opt-out is not consistent
  - but initial opt-in is important for service providers
  - note that all regulated service providers need to provide data

- The TFP design should not diminish the efficiency properties:
  - longer regulatory periods improve efficiency but are not essential
  - efficiency carryover mechanism cannot exist
  - a fixed X or a rolling X provide differences but these are not significant
  - periodic price-cost realignment is still required. The methodology is important.

Cost recovery and investment incentives

- The Revenue and Pricing Principles require that service providers are given a reasonable opportunity to recover efficient costs
- TFP is consistent with this:
  - recovery of efficient costs over the long term for service providers that at least achieve the industry productivity growth
  - use of same RAB roll forward approach
- If a service provider cannot achieve average industry productivity growth then there may be a case for an adjustment or safeguard mechanism but:
  - should not be routine or ‘normal’
  - should not be used to address short term issues
  - does add complexity and increases the reliance on firm-specific information

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