

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

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Draft Report Stakeholder Workshop -29  
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Draft Recommendations and Way Forward

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# Key Messages in TFP Draft Report

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- A TFP methodology would provide stronger incentives to the service provider to be efficient compared to current building block approach
- Possible for a TFP methodology to provide reasonable opportunity to recover efficient costs subject to design including regular prices resets or safeguard mechanism
- Hence TFP methodology would promote the national energy objectives
- A number of conditions need to be met for a TFP methodology to work. Crucially, the condition of having a robust, consistent data-set cannot be met today. Immediate focus should be on developing reporting requirements. The collection of data would enable the AER to test for the other necessary conditions and do paper trials.

# Key Messages in TFP Draft Report

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- Unlikely for TFP to be effective in transmission given the difficulty in defining transmission outputs, lumpiness of investment and the small number of service providers in the sector
- Propose a initial Rule amendment which a) would require service providers to provide necessary data and b) facilitate testing of conditions and paper trials
- Data reporting requirement should be place on both transmission and distribution service providers as improving the regulatory data would improve current building block approach and transparency for stakeholders
- Deferring the implementation of a TFP methodology to later would allow proper consideration of the impact on smart grids and climate change policies.

# Chapter 3: Assessment of TFP against the National electricity and gas objectives

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- A TFP methodology as an alternative option to building blocks should be included in the NER and NGR because:
  - it provides better incentives to service providers to improve operational efficiency and still allows for the recovery of efficient costs
  - it can provide a reasonable opportunity to recover efficient costs under defined conditions.
  - it will better promote the seeking out and implementing of innovations in service provision for service providers due to being compared to industry peers
  - Better demand management incentives
- Economic Insights modelling helps to confirmed this assessment
- Possible additional benefits of lower costs of regulation and less likelihood of appeals but this will depend upon design
- Therefore a TFP methodology is consistent with the NEL/NGL Revenue and Pricing Principles
- For TFP to be applied successfully and deliver these benefits, a number of conditions need to be met and the TFP methodology must be applied in a certain manner.

# Chapter 4: Necessary Conditions for TFP

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- Conditions needed are:
  1. Consistent and robust data
  2. TFP index is an accurate, robust and external measure of industry productivity
  3. Service providers within the industry group have comparable potential for productivity improvements
  4. Future operational conditions similar to past
  5. TFP index cannot be manipulated by service providers
- Condition 1 – is not satisfied. Need Rule to facilitate necessary data collection
- Condition 2 – can be met for distribution sectors. Various approaches to doing TFP index specification but these disagreements can be resolved
- Condition 3 – possible. Need data to test this.
- Condition 4 – maybe for distribution sectors. Possible not for the immediate future given climate change and smart meters but maybe in the future.
- Condition 5 – Yes, very difficult for one service provider to game TFP index.
- **Potential for a TFP methodology to be applied in gas and electricity distribution sectors but need to collect data and do some future condition testing.**

# Chapter 5: Way forward for implementing TFP

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- Implementation should be split into two stages:
  - Stage A: Initial Rule to collect data and facilitate possible TFP implementation at a later date
  - Stage B: Rule to set out detailed design and application of a TFP methodology
- Draft of Stage A Rule to be included with the Final Report. MCE will then decide whether to submit rule change proposal
- Data collected under Stage A Rule would enable the regulator to develop TFP indices, test the range of possible conditions and do analysis on some of the design aspects of a TFP methodology (i.e., definition of the industry)
- Stage B Rule to be possibly done once conditions needed for TFP are likely to be satisfied. However need to review whether a TFP methodology would promote national objectives given the stage of market development before starting this stage

## Chapter 5: Way forward for implementing TFP (2)

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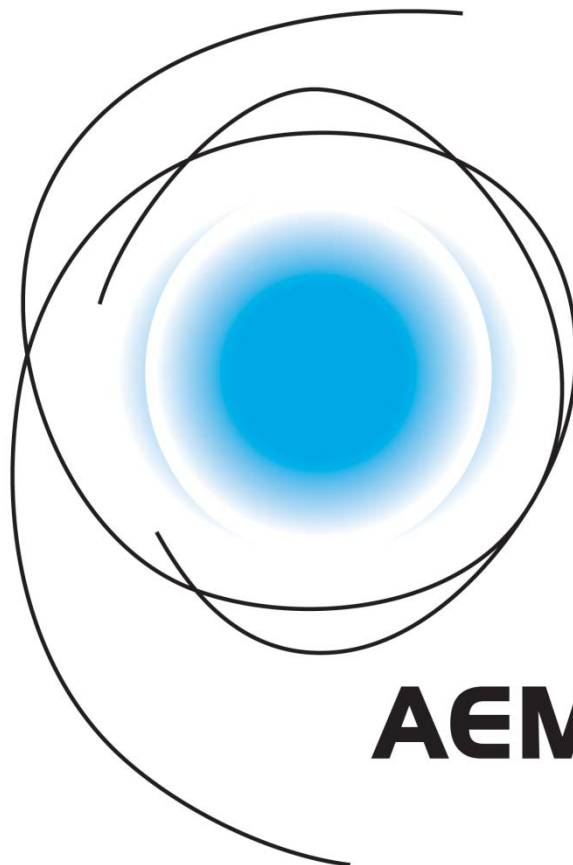
- Initial Rule to facilitate the possible implementation of the TFP methodology would cover the following:
  - Reporting of necessary data for a TFP methodology
  - Requirement on regulator to produce annual TFP index and calculation report
  - Testing of the data
  - Conditions needed to be met before TFP methodology could be applied
  - Framework for the AER to propose rule change once it considers the conditions needed for TFP can be met
  - Principles for calculating the TFP index
- Need for a specific obligation for the business to provide data in the Rules. This is a new obligation outside of the AER's existing information powers
- Data requirements to be specified in the Rules. Supporting definitions and guidelines to be developed by AER, consulting with the industry
- Need to give some direction on how the TFP index specification should be calculated

# Next Steps

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- Submissions closed on 24 December 2010
- Final Report with draft Rule to be submitted to MCE by end of Feb 2011
- Re-open the assessment of the Victorian Rule change request in 2011





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