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BY EMAIL TO: aemc@aemc.gov.au

(And through the electronic lodgement facility)

Dear John

Re: Draft Report. Review into the use of total factor productivity for the determination of prices and revenues

In its draft report, the AEMC has recommended that an initial Rule be made which requires service providers to provide specified regulatory data for the purpose of developing total factor productivity indices. The data would then permit the AER to test for the conditions necessary for a TFP methodology, and to undertake trials. The AEMC has stated that the regulatory data would also assist the AER in meeting its obligation to have regard to efficient benchmarks when making regulatory determinations under the current building blocks methodology. Furthermore, the development of TFP indices for the energy sectors could be used to guide wider policy decisions.

United Energy Distribution and Multinet Gas (“the Companies”) believe that a Rule to facilitate data collection is unnecessary and could have unintended and undesirable ramifications. The AEMC has not published a draft Rule because a Rule change consultation has not yet taken place. However, the AEMC has signalled its intent through the publication of a statement that:

The benefit of having this separate rule is that it will remove uncertainty [about] what information is to be provided for revenue decision-making processes, and prevent service providers from delaying revenue determinations and information gathering processes by questioning of, or seeking justifications for data requests from the AER¹.

¹ AEMC (2010) Draft Report. Review into the use of total factor productivity for the determination of prices and revenues. Australian Energy Market Commission, 12th November 2010. See page 96.

The Companies believe that the AER could use the Rule to make frequent and wide-ranging requests for information which is only narrowly related to the express purpose of examining and testing TFP methods. Accordingly, the Companies support the position taken by the Energy Networks Association (ENA) which is that the proposal by the AEMC to create new information collection provisions through the exercise of the rule making function would diminish or undermine the safeguards that are currently available under section 28 of the National Electricity Law. The measures that may be taken to extend and replicate the information collection powers of the AER would be contrary to the policy basis of the existing regulatory framework.

Background to information gathering processes

The current policy settings in relation to information gathering were determined subsequent to a report on energy access pricing which was prepared for the Ministerial Council on Energy by an expert panel². The expert panel, which was comprised of independent consultants, recommended that the framework for information gathering powers should be common across the energy sector, and should comprise:

- a) Statutory powers for the AER to obtain information that is relevant to the performance of its economic regulatory functions from any person.
- b) Statutory guidance to the AEMC concerning the scope and content of Rules prescribing regular regulatory reporting requirements.
- c) Rules promulgated by the AEMC specifying the scope and content of regular reporting requirements; and
- d) Guidelines issued by the AER, in accordance with the Rules, specifying the format, requirements and timelines for regular reports.

The Panel concluded that there was no need for information gathering powers to be given to the AEMC at this stage. It also recommended that the statutory powers of the AER should be modelled on section 28 of the National Electricity Law (NEL).

Furthermore, the panel considered that the statutory guidance to the AEMC - for the development of Rules dealing with the AER's information gathering powers – should specify that the Rules may:

- a) Provide for annual reports of regulatory accounting information relevant to the economic regulatory functions of the AER.
- b) Provide for periodic reports of non-financial information relevant to the AER's economic regulatory functions.
- c) Provide for the manner in which such information is to be attested by the service provider and be independently audited;
- d) Provide for the provision of equivalent information by contractors to the service provider where such information is relevant to the AER's economic regulatory functions.

² Expert Panel on Energy Access Pricing, Report to the Ministerial Council on Energy, April 2006.

- e) Provide for the disclosure (and protection) of such information, subject to its presentation in a manner that is not materially detrimental to the business or financial interests of the service provider; and
- f) Require the AER to have regard to the relevance of the information which it requires to be reported, and to the costs incurred by the information provider, and to the efficiency and effectiveness of the regulatory process and its objectives.

The Panel also stated that the NEL should be amended to include equivalent provisions.

The final recommendation about the **relevance** of the information required is a particularly pertinent one.

The MCE adopted the recommendations of the expert panel and stated that it agreed with the panel's concerns about information provision³. In its response to the expert panel report, the MCE directed that the National Electricity Law (NEL) and the National Gas Law (NGL) should be amended with a view to fulfilling the following objectives:

- a) Conferring powers upon the AER to obtain information from any person that is relevant to the performance of its economic regulatory functions. These powers would be modelled on s. 28 of the NEL.
- b) Giving responsibility to the AER to obtain and compile information and data for using TFP as a regulatory tool.
- c) Facilitating and enabling the issuance by the AER of regulatory information instruments for network service providers and their associates. The instruments would make provision for:
 - i. Reports of regulatory accounting information relevant to the economic regulatory functions of the AER.
 - ii. Periodic reports of non-financial information that is relevant to the AER's economic regulatory functions.
 - iii. The manner in which the service provider is to attest to such information, and whether or not the information is to be independently audited.
 - iv. The supply of equivalent data by contractors to the service provider, where such data and information is relevant to the AER's economic regulatory functions.
 - v. The disclosure (and protection) of such information, subject to its presentation in a manner that is not materially detrimental to the business, or to the financial interests of the service provider.
 - vi. A framework for the AER to have regard to the relevance of the information which needs to be reported, and to the costs incurred by the information provider, and to the efficiency and effectiveness of the regulatory process and its objectives.
 - vii. A framework related to the AER's ability to deal with confidential information, and to the implementation of its general function of performance reporting.

³ 2006 Comprehensive Legislative Package: Overview and Response to Expert Panel on Energy Access Pricing.

- viii. An ability for the AEMC to make and maintain Rules which specify the scope and content of regular reporting requirements; and
- ix. An ability for the regulatory information instruments to specify the format requirements and timelines for regular reports and information disclosure for regulatory resets and reviews of access arrangements.

The policy objectives were aimed at ensuring that the AER would be able to collect the information that it required, however the regulator's information gathering powers would also be circumscribed. Importantly, the criterion of relevance to the economic regulatory functions of the AER would need to be satisfied. In addition, the AER would need to consider the efficiency and effectiveness of the regulatory process, and to have regard to the costs that would be imposed upon the information provider.

Section 28 of the National Electricity Law (NEL) provides certain protections for regulated, network service providers, and also describes particular processes which must be followed. Amongst the protection mechanisms is a requirement that a regulatory information notice (RIN), or regulatory information order (RIO) must not be made for the purpose of instituting and conducting appeals. Furthermore, information should not simply be gathered for the purpose of preparing a service provider performance report. The specific extract from section 28F is reproduced below:

(3) A regulatory information notice must not be served, or a general regulatory information order must not be made, solely for the purpose of—

(a) investigating breaches or possible breaches of provisions of this Law, the Regulations or the Rules, including offences against this Law; or

(b) instituting and conducting proceedings in relation to breaches of provisions of this Law, the Regulations or the Rules, including offences against this Law; or

(c) instituting and conducting appeals from decisions in proceedings referred to in paragraph (b); or

(d) collecting information for the preparation of a service provider performance report;
or

(e) any application for review of a decision of the AER under Division 3A of Part 6.

On questions of process, section 28 stipulates that the AER should consult before publishing a general regulatory information order, and should also give the regulated network service provider an opportunity to be heard in advance of a RIN being served upon the business.

Although the NEL generally takes primacy over the NER, there is a potential for a new Rule put forward by the AEMC to erode or otherwise compromise the protection mechanisms inherent in section 28. The proposed Rule could also complicate or cause confusion in relation to the procedural requirements spelt out in the NEL.

Economic Regulation of Transmission Services Rule (the “Revenue Rule”)

In its determination on the Economic Regulation of Transmission Services⁴, the AEMC deliberated on the matter of the information gathering provisions in the Rules. The AEMC stated that one of its primary considerations was not whether or not the AER has adequate information gathering powers, but whether the powers are appropriately circumscribed by the powers and functions of the AER as set out in the NEL. The AEMC expressed concern that the information gathering powers available to the AER at the time were potentially too broad, and were inadequately correlated with the normal functions that would be carried out by the AER⁵. Regulatory certainty and transparency would only be promoted if there was a closeness of connection between the information collection powers and the functions and responsibilities exercised by the AER.

The AEMC also gave recognition to the phenomenon of “regulatory creep”, stating pointedly that regulatory requirements for information can increase progressively over time, and may result in information being sought for purposes other than the initial intended purpose. The AEMC therefore reiterated concerns which had previously been raised by the Productivity Commission in its review of the national gas access regime. The Productivity Commission had noted that regulatory creep might arise under a monitoring regime, if regulators expanded the information burden over time, thereby transforming monitoring into de facto price regulation. In the case of gas pipelines, the PC opined that there should be upfront determination of the data to be reported by the service provider. However, the PC acknowledged that specifying the requirements might not prevent regulatory creep if regulators were charged with the responsibility for performing these tasks. In order to reduce the incentives for a broadening of information gathering, the PC deduced that the body responsible for developing and updating the information requirements should be independent of the regulator undertaking the monitoring function.

When developing the final Revenue Rule, the AEMC sought to maintain amendments, introduced in the Draft Rule, which would ensure parity between the information gathering powers available to the AER and the functions to be performed. The principal roles of the AER in transmission regulation were set out as follows:

- Making future revenue determinations under Chapter 6A of the Rules.
- Monitoring, reporting and enforcing compliance with transmission determinations.
- Monitoring, reporting on and enforcing compliance with the transmission network service provider’s cost allocation methodology.
- Monitoring and reporting on the performance of the TNSP with any applicable service target performance incentive regimes; and
- Preparing and publishing annual performance statistics in relation to the service standards published by the TNSP.

When finalising the Revenue Rule, the AEMC claimed credit for clarifying the powers available to the AER for the exercise of its functions across the full gamut of regulatory and performance reporting responsibilities.

⁴ AEMC 2006, Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, Rule Determination, 16 November 2006, Sydney.

⁵ Page 115, AEMC 2006. Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, Rule Determination, Australian Energy Market Commission, 16 November 2006, Sydney.

Implications for TFP regulation of the policy framework and the Transmission Revenue Rule determination

In its review of the Rule for the regulation of electricity transmission revenue and pricing, the AEMC found that existing provisions within the NEL and the NER were sufficient to enable the AER to carry out its functions. The AEMC considered that there was a substantial information asymmetry between well-informed service providers and the less informed regulator, but believed that the best way of redressing the deficiency was to incorporate incentive mechanisms which would encourage TNSPs to reveal their efficient costs.

From the perspective of the current TFP review, the Companies believe that the AEMC has not adequately demonstrated the case for a new Rule aimed at the collection and compilation of supporting data. In an earlier submission to the Review, the Companies argued that existing provisions within the NEL and the NGL permitted the sourcing of data that could be used to support the application of TFP within a regulatory process⁶. The AER could consult on an industry-wide Regulatory Information Order (RIO) which would be used to facilitate non-overlapping information requests from service providers. Accordingly, the Companies perceived that there was no requirement for new or amended information gathering powers. That view has been maintained to-date.

The Companies also endorse the position advanced by the ENA which is that any departure from the approach expounded by the AEMC in the Transmission Revenue Rule determination would be unwarranted⁷. The AEMC has not been instructed to re-examine the policy issues associated with information collection powers under national energy laws. The AEMC has consequently been unable to establish a strong case that the existing provisions for information collection are inadequate.

The AEMC engaged Economic Insights to provide an assessment of whether currently available data and current regulatory reporting requirements are sufficiently robust and relevant to adequately support the implementation of a TFP methodology. While the terms of reference may not have included a direction to Economic Insights to examine the adequacy of the existing Rules, the Companies note that the consultants have not identified the need for a Rule change. Economic Insights reported that the AER's draft RIO could be extended to include more quantity information on both outputs and inputs, and to ensure that the costs data collected was consistent with TFP requirements⁸. Economic Insights claimed that the provision of the extra information would not impose a considerable burden on regulated businesses, because the information would be "basic" and its compilation would fall within the bounds of capability of a "well run network business". The statements by Economic Insights do not align comfortably with the arguments for a Rule change that have been advanced by the AEMC.

The Companies remain concerned that a new Rule put in place by the AEMC would potentially conflict with the policy stance adopted by the MCE when it accepted the recommendations of an expert panel review into energy access pricing. If the AEMC does, however, insist on the implementation of the new Rule, then a set of protections equivalent to those in section 28 of the NEL should be developed for incorporation into the stage one Rules.

⁶ Preliminary findings of the review into the use of total factor productivity for the determination of revenues and prices. Submission to the AEMC by United Energy Distribution and Multinet Gas, 26th February 2010. See page 22.

⁷ Response to Australian Energy Market Commission. Draft Report – Review into the use of total factor productivity for the determination of prices and revenues. Prepared by the Energy Networks Association, 17th December 2010.

⁸ Assessment of Data Currently Available to Support TFP-based Network Regulation. Report prepared for the Australian Energy Market Commission, 9th June 2009. See page 43.

As mentioned previously, the AEMC has contended that a separate Rule would confer a benefit by removing uncertainty about the type of information that needs to be provided for revenue decision-making processes⁹. However, in practice, the Rule is unlikely to eliminate uncertainty, and may only ameliorate it modestly. This is because the precise manner in which the data requirements are specified is likely to be of greater importance than the Rule itself. The Companies would need to investigate whether information technology systems are in place to ensure that the relevant data series are recorded systematically and in a timely manner. Customised error checking procedures, both automated and manual, would also need to be implemented. The Companies would want to be assured that the regulatory process would enable the recovery of costs associated with the implementation of systems and processes to gather the requisite information. The Companies believe that if a Rule were put in place, notwithstanding the objections raised by regulated service providers, then, at the very least, the Rule should not be overly prescriptive.

The AER considers that only minor changes to the NER and the NGR would be needed in order to verify the requirement for the regulator to collect information for the exercise of its duties and discharge of its responsibilities. The AER has suggested that a single statement in the NER, which confirms that TFP is intended to be a viable and practical regulatory option, would assist in the timely collection of relevant data. In essence, the NER and the NGR should convey a message that the regulatory reporting regime is capable of supporting the application of both the building block approach and a TFP methodology. However, the AER does not believe that detailed data requirements should be set out in the NER and the NGR. Instead, the regulator has asserted that a RIN or RIO would be better suited to the task of eliciting specific types of information¹⁰.

Other aspects of the TFP review

The AEMC has held that the conditions necessary to facilitate the introduction of a TFP methodology into the regulatory regime are not prevalent in regulated energy sectors, at present. The AEMC has therefore postponed the detailed design of a TFP method, and will not instigate a Rule change aimed at bringing about a TFP based regulatory approach. As part of its two-pronged approach to TFP, the AEMC has pledged to commence drafting the detailed design of a TFP method once certain conditions have been met.

The AEMC has also resiled from affirming any principles which might be germane to the future application of a TFP regime. The Companies consider that the AEMC's failure to provide any form of commitment about the salient features of a future TFP method constitutes a weakness of the draft report.

A fundamental principle which ought to be upheld is that of "optionality". The Companies believe that the AEMC should ratify the position taken in the Preliminary Findings paper, which was that:

⁹ AEMC (2010) Draft Report. Review into the use of total factor productivity for the determination of prices and revenues. Australian Energy Market Commission, 12th November 2010. See page 96.

¹⁰ AER submission to the "Preliminary findings of the review into the use of total factor productivity for the determination of prices and revenues". Australian Energy Regulator, 3rd March 2010. See page 2. The AER wrote that "it would be preferable for data requirements for a TFP methodology to be detailed in a regulatory information notice or order rather than included in the NER or NGR".

The initial selection of a TFP methodology and its continued application beyond the first regulatory control period would be a decision for the service provider. No approval of the regulator would be required¹¹.

There should be no avenue available by which a regulator or third party could impose a TFP method upon a service provider without the latter's consent. The TFP method should be available as an alternative to be assessed voluntarily, and not as a replacement for the building blocks approach. Only service providers should be able to initiate the transition from the building blocks approach to a TFP methodology.

An important corollary to "optionality" is that there ought to be a mechanism by which service providers can revert to a building blocks form of regulation.

The Preliminary Findings stated that:

A service provider may return to the building block approach after a regulatory period using a TFP methodology if it can satisfy the regulator that under a TFP methodology it will not have the opportunity to recover efficient costs over the long term¹².

An "exceptional circumstances" test would reduce the scope for gaming and ensure that only service providers with confidence in the TFP methodology would switch from the building blocks approach. The existence of such a test would also contribute to ensuring that the design features of a TFP approach are fully developed up front.

Should you or your staff have any queries in relation to this submission, please do not hesitate to contact Jeremy Rothfield, Regulatory Economist, on (03) 8540 7808, or Andrew Schille on (03) 8540 7818.

Yours sincerely

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Regulatory Manager

¹¹ AEMC (2009). Review into the use of total factor productivity for the determination of prices and revenues. Preliminary findings, 17th December 2009, Australian Energy Market Commission. See page 101.

¹² AEMC (2009). Review into the use of total factor productivity for the determination of prices and revenues. Preliminary findings, 17th December 2009, Australian Energy Market Commission. See page 100.