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By email to: submissions@aemc.gov.au

Dear Mr Graham

Consultant Reports for Review into the Use of Total Factor Productivity for the Determination of Prices and Revenues

EnergyAustralia welcomes the consultant reports relating to the AEMC's current review into the use of total factory productivity (TFP) for the determination of prices and revenue. We found these reports very helpful in providing further insights into the strength of the incentives under a TFP approach, the relevance and robustness of the current available data for the application of TFP and the sensitivity of variations in the specification of a TFP model. These reports therefore have contributed greatly to the current review (and debate) regarding the appropriateness of a TFP approach to the determination of regulated prices and revenues.

There are two aspects of the reports that we would like to comment upon: namely, the cost of collecting appropriate data for a robust application of a TFP approach; and the contention that businesses can exploit the information asymmetry between the businesses and the regulator so as to extract higher prices.

Firstly, in relation to the robustness and relevance of currently available data for the application of a TFP method, Economic Insights found that the data currently available is not fit for the purpose of applying TFP to determine regulated price and revenue.¹ Economic Insights suggested that the AER's proposed Regulatory Information Order² could be extended to include the information necessary for the application of a TFP methodology. Economic Insights concluded that the true cost of extending the

¹ Economic Insights Pty Ltd, *Assessment of Data Currently Available to Support TFP-based Network Regulation*, 9 June 2009, page v.

² AER, *Issue Paper: Electricity distribution network service providers: Annual information reporting requirements*, August 2008.

reporting requirements is likely to be relatively small, despite submissions from the businesses that the AER's proposed RIO is a major annual compliance burden.³

Having considered the AER's proposed RIO in detail, EnergyAustralia is concerned with the assumption made by Economic Insights that the cost of further extending the information requirements is relatively small. EnergyAustralia wrote to AEMC in February 2009 arguing that the costs of complying with the RIO could be significant if the information requirements do not align with current business reporting process and therefore require expensive IT system changes. Further costs could be imposed if new data collection processes and procedures are required to satisfy the information requirements contained in the proposed RIO⁴. The costs and annual compliance burden may be exacerbated with the additional reporting requirements as suggested by Economic Insights, especially as it is unknown as to the scope of the further information required.

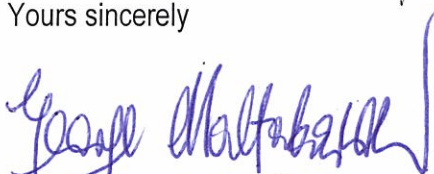
Secondly, the Brattle Group stated that one of the weaknesses of the building block approach is the information asymmetry between the businesses and the regulator and that businesses can exploit this weakness to extract higher price/revenue.⁵

Whilst we acknowledge that perfect information symmetry between the business and the regulator cannot be achieved, we note the substantial information gathering powers afforded to the AER under the National Electricity Law and the significant penalties attached to non-compliance⁶. Furthermore, failure to comply with a request for relevant information may result in the Australian Competition Tribunal refusing leave to apply for merits review of a decision by the AER even if other grounds for the application for leave were made.⁷ This arrangement would therefore partially reduce the information asymmetry between the businesses and the regulator.

We also note that a TFP approach side-steps the issue of information asymmetry by using the industry growth rate to set the price increases rather than using the firm's own forecasts of costs. This, however, gives rise to other issues of concern we have raised previously in submissions on the use of TFP, ie how to define an appropriate industry and whether an industry growth rate would afford the business with a reasonable opportunity to recover at least the efficient costs.

If you have any questions or would like to discuss any aspect of this submission in greater detail, please do not hesitate to contact Mr Trevor Armstrong on 9269 2611.

Yours sincerely



GEORGE MALTABAROW
Managing Director

³ Economic Insights Pty Ltd, *Assessment of Data Currently Available to Support TFP-based Network Regulation*, 9 June 2009, page 43.

⁴ See EnergyAustralia's submission on the AER's issue paper on the proposed RIO available at <http://www.aer.gov.au/content/index.phtml/itemId/722456>

⁵ The Brattle Group, *Incentives Under Total Factor Productivity Based and Building-Blocks Type Price Controls*, June 2009, pp viii, 33-34,44.

⁶ See Division 3 of the Schedule – National Electricity Law, National Electricity (South Australia) Act 1996, 1 Jan 2008.

⁷ See clause 71H(2) of the National Electricity Law.