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Our Reference: UE SU

By e-mail: submissions@aemc.gov.au

Dr John Tamblyn
Chairman
Australian Energy Market Commission
Level 5, 201 Elizabeth Street
Sydney NSW 2000

Dear Dr Tamblyn

Total Factor Productivity Rule Change Proposal

United Energy Distribution Pty Limited (UED) has reviewed the Total Factor Productivity Rule Change Proposal (the TFP Proposal) submitted by the Victorian Department of Primary Industries.

UED has been and continues to be a committed proponent of innovation and development in regulatory design in furtherance of the National Electricity Objective. There have been significant gains on many fronts under the building blocks method with consumers, service providers and society in general all benefiting. However, as regulators now apply it, the building blocks method has many of the characteristics of cost of service regulation and service providers are responding accordingly. A new approach is required if the industry is to be encouraged to undertake the changes necessary to realise further significant efficiency gains and service innovation.

UED sees alternative regulatory approaches where the linkage between costs and revenues is relaxed, as the way of the future. TFP regulation, in its purest form, is one such alternative. However, the TFP Proposal as submitted does not live up to that promise. In particular re-setting revenues/prices to costs at each review maintains the linkage and requires the regulator to make the same sorts of judgements that have been so problematic for the building blocks method. The only practical difference between building blocks as it is applied and the proposed TFP approach appears to be a different method of setting X.

The scheme envisaged by the TFP Proposal appears likely to be inflexible in application and unresponsive to innovative ideas as a result. It also leaves open a number of matters (such as the form of the TFP model and sourcing of data) that are likely to be highly contentious.

TFP regulation is just one of a number of potential alternative approaches, and the TFP Proposal offers a particular implementation of TFP regulation. The AEMC's consultation is constrained accordingly. In UED's view, if resources are to be committed now to considering alternative forms of regulation then a wider view should be taken. At the same time it must be recognised that prescriptive schemes have limitations in that they are generally designed to apply on a one-size-fits-all basis and will inevitably be a second best option for some service providers and their consumers. UED's preference is for a less prescriptive and more flexible approach where the service provider and the regulator can develop a tailored "compact" in consultation with stakeholders, including consumers. The test for acceptance of such a compact would be that it conforms to the National Electricity Objective and the Revenue and Pricing Principles. The aim must be a system that encourages and rewards innovations that deliver consumer benefits.

Comments on the TFP Proposal

UED has a number of high-level observations to make on the TFP Proposal itself. Assuming that the Commission will continue to consider the TFP Proposal under the rule change process, we anticipate making submissions at a more detailed level at later stages in the consultation.

- A threshold issue for UED and, we understand, for other distribution businesses, is that it must be for a business (and the business alone) to initiate the transition from building block to TFP regulation – there must be no avenue for TFP regulation to be imposed on a business without its consent. It is pleasing to note that the TFP Proposal provides for that election.
- There are presumptions about process and structure in the TFP Proposal that have not been tested, such as:
  - the extent to which important matters of detail should be left to non-binding guidelines to be developed by the AER;
  - the various discretions that will be conferred on the AER in applying TFP; and
  - having the decision on eligibility to move to TFP made as part of the price review process.

  The rule-change process is not necessarily the best framework in which to test these presumptions because they are integral to the structure of the TFP Proposal.
- As noted previously, by including a P_0 adjustment to "efficient costs" at each review, the TFP Proposal is perpetuating the very problem that besets the building block method as it has been applied. That is that nobody, including the regulator, knows what the efficient costs are for a business.

  At a superficial level, the TFP Proposal involves little more than replacing one method of determining X which is acknowledged to be error-prone, with another that is equally susceptible to error.
- It is UED's understanding that WACC and depreciation will continue to be key inputs to the assessment of the P_0 adjustment at the time of reviews as well as for the ongoing calculation of TFP and performance monitoring. The TFP Proposal is silent on the question of WACC. In fact under the draft rule change a service provider would not be required to make a submission on WACC as part of its pricing proposal (see proposed Schedule 6.1A (b) which omits reference to clause S6.1.3(9)). On depreciation, the TFP Proposal stipulates that "for the purposes of applying clause S6.1.3(12), depreciation is to be calculated on the basis of the actual depreciation of the assets concerned." (see proposed Schedule 6.1A (c)) "actual depreciation" is not defined.

  Issues around the setting of WACC contribute significantly to the cost of building block regulation. While the scope for debate is likely to be reduced once the AER has completed its review of WACC parameters, WACC will continue to be an important input for TFP regulation.

- One of the advantages claimed for TFP regulation is that it obviates the need for consideration of forecasts thereby eliminating one of the more contentious aspects of the building blocks approach and reducing the cost of regulation. However, there are at least two instances in the proposed scheme where there is an implicit, if not explicit, requirement for forecasting e.g. in the criteria for deciding whether a business is eligible to choose TFP regulation (see proposed clauses 6.2.4A (b)(2) and (3)) and in applying the "TFP Criterion" (see proposed clause 6.6A.3).

  It is difficult to see how the revenue and pricing principles in section 7A of the NEL and s7A(2) in particular, can be satisfied without regard to forecasts.

- The eligibility test in proposed clauses 6.2.4A (b)(2) and (3) also highlights the tension that exists between the TFP methodology, where revenues/prices and costs are de-linked, and the objective in s7A(2) of the NEL. The test effectively places the AER in the unusual position of ensuring that a service provider is protected from the consequences of what might be a bad business decision where it concludes that the business's TFP growth is likely to be less than the industry average. The test is also intended to ensure that a business whose TFP growth is likely to exceed the industry average does not enjoy excessive gains. This intention is confirmed at page 39 of the TFP Proposal:

  > There are a number of measures in the Rule proposal that, in combination, should ensure that [s7A(2) of the NEL is satisfied], including:
  >
  > ... to preclude the TFP approach from being applied where the productivity growth for the distributor in question is expected to be materially different to that of the industry as a whole;

- The TFP Proposal does not identify decisions that should be reviewable. There are a number of decisions in the proposed scheme that are likely to have significant consequences for businesses and that should be reviewable. These include decisions to:

  - withhold consent for a business to move from building blocks to TFP or from TFP to building blocks;
  - add (or continue to include) data for particular businesses in the X factor data pool;
  - vary the form of the TFP model i.e. to vary the specification of input and output measures and/or their weightings; and
  - disallow pass through of a cost.

Should you wish to discuss this submission please contact Andrew Schille on (03) 8544 9432.

Yours sincerely

Hugh Gleeson
Chief Executive Officer