

**Larry Kaufmann Presentation to Total Factor Productivity Review: Design Discussion Paper
Workshop – Gas Sector**

Rydges World Square, Sydney Australia October 2, 2009

Good afternoon everyone, and thank you for the opportunity to address this Workshop on the TFP Design Discussion Paper. For those of you who don't know me, my name is Larry Kaufmann and I've been advising companies and regulators in Australia and New Zealand on regulatory issues for the last 12 years. I've also worked on empirical TFP studies in the United States, Canada, Mexico, Japan, Germany, Bolivia, Argentina and Jamaica. My comments today will draw on my experience and the lessons I've learned from the practical implementation of productivity-based regulation in a variety of diverse environments.

I've read the Design Discussion Paper, and in general I'm pleased with the direction it's taken. There are many aspects of the paper that I support and some I don't. Because my time here is short, I won't address these points in detail but rather will make some high-level comments that can perhaps help to structure and discipline the debate going forward. My remarks here are also generic and apply to both the gas and electricity sectors.

First, I think it's important to recognize that productivity-based regulation has been done many times before. I'm aware of at least 42 separate instances where regulators have set the X factor in a "CPI-X" plan using evidence on industry TFP growth. In addition to gas and electric distributors, these applications include plans for the regulated services of bundled power utilities, gas pipelines, oil pipelines, telecom companies, and railroads. In every single one of these applications – except one – the TFP specification that was used by the regulator conforms with the approach that I've used to estimate TFP in my work for the ESC in Victoria. This is the same methodology that I've recommended for this review. The single exception is the plan that was approved for electricity distributors in New Zealand in 2004 which, I'm sure most of you know, is the approach that Economic Insights is recommending for this review.

It's important to keep these facts in mind as you consider the rival TFP methodologies that have been debated in Australia. There is a fair amount of common ground in these methodologies but, on the parts where they differ, it's not an exaggeration to say that one approach is "tried and true" and the other is a one-time experiment. Because the Economic Insights approach has only been implemented one time, I believe the experience with how this experiment has played out in New Zealand can be a valuable source of information for this review. I would therefore encourage the AEMC and all other interested parties to examine the NZ experience objectively and impartially. This would include a review of the debates surrounding the initial price controls established in 2003-04; the updated TFP and benchmarking results presented for the proposed update of those controls in 2007; the industry and Parliamentary reaction to the 2007 updated TFP levels and trend results; and the current proposals before the Commerce Commission.

I would also encourage the AEMC to review the experience with TFP-based regulation in other jurisdictions, and one jurisdiction that I would particularly recommend is Ontario. One of the things I liked about the Discussion Paper is its familiarity with productivity-based regulation in Ontario, especially the incremental capital module that was part of the “third generation” PBR plan approved in 2008. Observers here may be less aware that this third generation plan was explicitly designed to put PBR on a more firm conceptual foundation, since before that time PBR in Ontario evolved in fits and starts rather than through a consideration of first principles. This makes Ontario’s third generation PBR plan especially instructive for this review, for at least two reasons. One is that this review process is also focused on long-term regulatory stability. A second is that the Ontario plan was designed to apply to more than 80 different electricity distributors operating under a wide array of operating conditions, and the current proposed rule change also potentially applies to a large number of diverse utilities.

One specific issue from Ontario that was mentioned in the Discussion Paper concerned the measurement of capital. The paper noted that the issue of physical vs monetary capital measures was extensively debated in the third generation plan in Ontario, and the regulator came down strongly and unambiguously against physical capital metrics. This is an important practical point for this proceeding, since this was the first time this issue was debated before an independent regulatory body where all proposals – including my own, as advisor to the regulators’ own staff – were evaluated impartially and on equal terms. I should point out that Economic Insights has recently disputed the claim that this issue was in fact “extensively debated” to which I respond – don’t take either of our words for it. There are full written transcripts for every day of the conferences in which parties testified in favor of their proposals (including myself, working on behalf of regulatory staff) and submitted to questions from Board members, regulatory staff, company personnel, and customer representatives. Interested parties can and should review the hours of time that were spent during the review process on the critical issue of how best to measure capital in TFP studies.

Before I conclude, I would like to respond to one specific point that appears in the Discussion Paper. On p. 26, the Discussion Paper says that Economic Insights has found that my recommendations for output choices are “based on the assumption that the energy distribution industry exhibits the characteristics of a competitive industry.” The first time I read this I could, literally, not believe my eyes. Remember that variants of this output specification have been applied more than 40 times to adjust prices for regulated services. It would be extremely surprising if, in all of these regulatory reviews, no one noticed that the TFP specification rested on an assumption which was so obviously untrue. Of course, it’s not true, as I will show why in a formal submission. This claim also demonstrates something important: Economic Insights has increasingly adopted the perspective of abstract economic theory rather than practical utility regulation. This is especially clear in its most recent work in New Zealand, which is focused on solving puzzles in the theoretical literature. Yes, there are interesting theoretical issues in the productivity literature which theorists should explore, but we shouldn’t let this distract us from the practical tools that exist now to address immediate regulatory problems. There are huge theoretical issues in modern physics as well; in some respects, the two great 20th century revolutions in physics – general relativity and quantum mechanics – are flatly contradictory. But when NASA was given the mission to put a man on the moon before the 1960s ended, it used the practical models of the universe that were appropriate to the job at hand rather than attempting to resolve fundamental theoretical discrepancies. Regulators should take a similarly practical, rather than theoretical, approach.

In closing, let me thank the AEMC for the opportunity to address this Workshop. I have supported productivity-based regulation as a supplement to Australia's regulatory framework since the first report written for the Victorian distributors in 1997. I have followed the AEMC's deliberations on the rule change application with interest, and I believe the Discussion Paper is a valuable and important step forward. I have also always kept an open mind in previous debates on these issues, and in fact have adopted suggestions put forward by other parties in my own TFP work and learned a great deal from these discussions. While the issues can be complex, I am convinced that an impartial and objective review of all the evidence – particularly the evidence from practical TFP applications, rather than abstract theoretical arguments – can lead to a successful resolution of the outstanding matters. Thank you again.