

**Incentive Regulation and Implementation
Total Factor Productivity (TFP)
Utility Regulators Forum**

Session Two -Implementation

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Friday, 9 May 2003

Stamford Hotel, Melbourne

- **Implementation (or way forward) if there is an interest in progressing consideration of TFP approaches**
- **Issues can be considered in phases**
 - ◆ Design and evaluation phase
 - ◆ Policy decision phase
 - ◆ Implementation phase

Design and evaluation phase

- Initial step is to gain better understanding of TFP design issues and options
- Must consider specific issues for industry sector
- Analysis to understand incentives created
 - ◆ Financial modelling greatly assists such analysis
- Suggest consultative or collaborative working arrangements with regulated companies and other stakeholder
 - ◆ Development of options
 - ◆ Consider detailed design questions
 - ◆ Understand whether preconditions met

Options for incorporating TFP into overall regulatory approach

- **“Strawman” TFP based approach is one option.**
- **However, other techniques and elements within this approach could be incorporated and blended together with the current building blocks approach.**
- **For example:**
 - ◆ **A TFP study could be used to cross check the setting of X within the current building blocks framework; or**
 - ◆ **A TFP study could be used to set X within the building blocks approach, with five yearly cost-based reviews continuing**
 - ◆ **A “Paper Trial” – the Strawman TFP approach (or similar) could be negotiated and applied in parallel**

TFP Strawman - Detailed Design Questions

- Establishment of a starting point price (Po)
- Review period
- Setting X based on TFP
- 'Z' factors
- Firm-specific cost adjustments
- Stretch factors
- Offramp criteria
- ESMs

Development of modeling tools to support design and analysis

- Suggest modeling and sensitivity testing based on realistic company data and available TFP data
- Compare TFP option(s) with Building Blocks
- Assist understanding of issues and outcomes
 - ◆ Design issues
 - Importance of company specific costs ?
 - Incentive and pricing effects of setting parameters?
 - Width of offramp deadbands,
 - Z Factor design
 - Are ESMs needed ?
 - ◆ Outcomes
 - Volatility of shareholder returns ?
 - Customer outcomes ?
 - Likely stability of regime under different parameters (ie likely frequency of triggering offramps)

Address company specific costs

- Undertake analysis to determine whether company specific cost issues are significant
 - ◆ If so, deciding whether these can be addressed systematically or whether a case-by-case analysis is needed
- Key issues are:
 - ◆ Whether a systematic approach to account for company specific cost differences is needed and , if so, achievable
 - ◆ If a systematic approach is not possible, whether it is acceptable for different regimes to operate in parallel within a regulatory jurisdiction
 - ◆ Whether, in practice the difficulties and uncertainties in incorporating company specific factors are significantly different from that under the building block approach

Clarify objectives and priorities

- **Clarify objectives and priorities**
 - ◆ What problem(s) trying to solve
 - ◆ What outcomes trying to achieve
 - ◆ Help make decisions and measure progress
 - ◆ Contribute to evaluation criteria

To what extent are the priority objectives

Efficient cost levels while assuring financial sustainability ?

Better promote productive and dynamic efficiency ?

Reduce regulatory costs ?

Decision process

- **Decision required:**
 - ◆ Would adoption of proposed TFP based approach be more consistent with objectives
- **Each regulator independent**
 - ◆ Ultimately each makes its own decisions within parameters of relevant jurisdictional instruments and specific objectives
- **National consistency desirable – national guidelines ?**
- **COAG proposal for National Regulator**

Identifying specific legal and regulatory impediments and developing potential enabling provisions

- **Some discretion for regulators in both electricity and gas but Codes do not clearly allow for all the detailed features of TFP based approaches**
- **Impediments in the National Gas Access Code, and National Electricity Code could be addressed through:**
 - ◆ **Comprehensive review**
 - ◆ **Targeted enabling provisions (Recommended)**
- **In introducing any such new concept, practical problems arise in that:**
 - ◆ **Code changes generally require considerable detail in order to secure stakeholder support and regulatory approvals - detail is not yet available**
 - ◆ **TFP would require a period of practical testing in the Australian context**
 - ◆ **Any transition to TFP would be gradual, and would not necessarily supplant building blocks for all entities or industries**
 - ◆ **Would run in parallel with the existing approaches**
- **Comprehensive review of the codes possible in longer term**

Agreeing and establishing data collection and TFP estimation methodologies

- **Suggest early decision taken on whether to establish data collection and TFP estimation methodologies**
 - ◆ TFP studies desirably based on long time series of consistent data
 - ◆ TFP estimates useful in any case for measuring economic performance
- **Considerable work required including:**
 - ◆ Developing and agreeing the TFP methodology
 - ◆ Defining the data to be collected
 - including developing an approach to estimation of capital costs
 - ◆ Establishing data collection and verification processes
- **Who should be responsible for undertaking TFP studies.**
 - ◆ In North America, consulting firms on behalf of the regulated companies undertake TFP studies
 - ◆ However, other options could be considered

Refining regulatory accounting and reporting

- Further effort likely to develop and maintain a robust regulatory accounting framework to support the evolution of regulatory approaches
- Note the Regulators Forum's current initiatives on achieving consistency in regulatory reporting within Australia

Participating in international data collection and benchmarking initiatives

- Internationally, benchmarking and data collection is attracting increased interest, most notably in Europe
- Primary function of benchmarking is decision support, rather than a replacement for regulatory judgment
- Jamasb and Pollitt argue it is important for regulators to collect national and international data through formal co-operation and exchange
- Focus on improving the quality of data collection processes, auditing, and standardisation within and across countries
- In our view, Australia should at least monitor developments in international benchmarking, particularly developments in data classification, and consider joining international benchmarking exercises and international studies of TFP

Reviewing the customer advocacy and decision-making processes

- Case studies suggest that evidence-based, judicial-style processes appear to lend themselves to the type of decision-making required in applying the outcome of a TFP study to the determination of X
- Issue that warrants further consideration
- Customer advocacy arrangements would need to be reviewed to ensure that they were appropriate