

19 November 2002

Mr John Martin
Utility Regulators Forum
GPO Box 520J
Melbourne Vic
3001

Dear John

Re: Comparison of Building Block and Index Based Approaches - TXU Networks Comments

TXU Networks has reviewed the above document prepared by Farrier Swier and would like to offer the following comments for consideration by the Utility Regulators Forum.

Overview

TXU Networks welcomes the current research and debate around the subject of methods of regulation that could be employed in the area of energy infrastructure. The Productivity Commission has also highlighted this issue in its recent review of national access regulation for essential infrastructure assets. The Commission specifically recommends that:

“The Commonwealth, States and Territories, through the Council of Australian Governments, should initiate a process to develop further the productivity measurement and benchmarking techniques necessary for regulators to make greater use of productivity-based approaches to setting access prices”.¹

TXU Networks recommends that any Council of Australian Government and Utility Regulators Forum processes be coordinated to ensure that these processes are implemented consistently.

TXU Networks has the following primary objectives from any regulatory regime:

- ? that there be a high level of regulatory certainty to enable TXU to predict revenue streams for our investors and financiers;
- ? that regulatory decisions are transparent and treat all regulated businesses equitably in relation to the specific circumstances of the business;
- ? that sufficient incentives are offered to facilitate efficient investment in assets and to reward efficient business operation; and
- ? the regulatory framework should be output focused rather than based on intrusive cost of service regulation.

¹ Productivity Commission: Review of National Access Regime, Inquiry Report No.17, 28 September 2001, p351.

TXU Networks would welcome any development that assisted with achieving the above objectives.

TXU Networks considers that the analysis initiated by the Regulator's Forum is important and may offer some benefit to regulated businesses and consumers. However, TXU Networks would like to caution against pursuing any change in the regulatory model without a thorough consideration of all the implications.

TXU Networks concurs with the conclusions of the report that more investigation is required and that currently there is insufficient information to accurately benchmark businesses without risk of regulatory error.

TXU Networks is keen to participate further in the debate and agrees that starting to gather relevant data is a good first step. TXU Networks view from reviewing the report is that a change to an index based methodology such as Total Factor Productivity (TFP) will require a significant period of review and debate prior to implementation.

Building Block Approach

The Building Block methodology has been used in Victoria since the privatisation of the Electricity businesses in 1995.

The building block approach offers incentives to outperform benchmarks and investors expect the business to seek out-performance against the benchmarks set. In doing so, benefits are passed to customers under the CPI-X formula and investors receive superior returns in the short term.

In comparison, TXU Networks does however feel that an appropriately structured Index Based approach could offer better incentives than the current regime. TXU Networks suggests that there are benefits in decoupling prices from a businesses cost base, as "efficient" businesses will earn superior profits relative to those who are less efficient.

Availability and Application of Benchmarking Data

TXU Networks agrees with the findings of the report, that currently there is insufficient robust data to undertake a benchmarking exercise of businesses in Australia and that there are significant risks of regulatory error if inappropriate benchmarks are used.

TXU Networks has a diverse geographic service territory and network configuration that is rarely replicated by other businesses around the globe. In TXU Networks case, there is a significant risk that under an index based approach, such as TFP that inappropriate benchmarks could be used to determine prices.

Comparison of TXU to businesses with differing network configurations or terrains would not offer meaningful results, unless there is some mechanism to recognise the specific circumstances of a particular business

Regulatory Certainty

A change in regulatory framework to a TFP method would be a significant undertaking and may have significant implications for prices. Indeed, a different regulatory approach would fundamentally change the character, scope and conduct of the regulatory process. Thus, any change to the regulatory regime introduces significant uncertainty.

As stated in the overview above, TXU Networks considers regulatory certainty to be a fundamental principle underpinning the regulatory framework. TXU Networks would therefore be reluctant to advocate any change until there was a thorough understanding of the impacts on distribution businesses and customers of a methodology change.

TXU Networks can also see some practical difficulties in using benchmarks derived by TFP to determine regulated prices (and therefore revenue). An increase in disputes is a likely outcome of changing to a TFP approach. Applying benchmarks is more subjective than using specific business costs and there will be winners and losers from the process. The Index Based mechanism needs to be designed in such a way to reduce the likelihood of disputes and allow a smooth transition between methodologies.

Summary of TXU Networks position

TXU Networks believes the investigation initiated by the Regulator's Forum is a positive development. TXU Networks would like to advocate that a joint Regulator and Industry Working Group be founded to achieve the following outcomes:

- ? Agree on the specific details of a proposed Index Based methodology;
- ? Identify data requirements and commence collection of data;
- ? Verify information collected and adjust as necessary to reflect the requirements of the methodology to be employed.

TXU Networks suggests that the review should incorporate Gas and Electricity.

TXU Networks is willing to participate in any working group formed and is keen that work start soon.

Yours sincerely

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TXU Networks