



UTILITY REGULATORS' FORUM:
INCENTIVE REGULATION AND IMPLEMENTATION
TOTAL FACTOR PRODUCTIVITY

MELBOURNE, 9 MAY 2003

“AN INDUSTRY VIEW”

Contact person: Trevor Lee
Group Manager Regulatory Affairs
Telephone: (07) 3404 1825



ECONOMIC REGULATORY REFORM: ELEMENTS

- Productivity Commission's Review of the National Access Regime
- Commonwealth's Response to the PC Review
- WA Supreme Court Decision (Epic Case)
- CoAG (Parer) Energy Market Review
- Proposed Gas Code Review
- Left field (eg: GasNet Appeal, NEM Ministers Forum Issues)
 - Macfarlane: National Energy Policy Statement later in year
 - PM: Energy Policy one of three top domestic issues



ELEMENTS: PRODUCTIVITY COMMISSION INQUIRY INTO NATIONAL ACCESS REGIME (SEPT 2001):

- Hilmer vision of dynamic efficiency, investment, innovation in reform not being achieved in practical application of regulation
- Need to overcome regulatory risk and investment deference
- Two types of error in decision-making
- ‘Chilling’ effect of limiting upside returns to investors (and dynamic efficiency) likely to outweigh any benefits curbing inefficient monopoly rents (allocative efficiency)
- Develop less intrusive forms of regulation, and explore productivity-based approaches (productive efficiency) and price-service offerings
- Regulators should not be too ambitious, intrusive:
 - aim only to improve on unregulated outcomes, not prescription of what should happen in detailed, precise way
- Effective appeal mechanisms



ELEMENTS: COMMONWEALTH INTERIM RESPONSE (SEPT 2002):

- AFR 3/10/2002: “Unmistakable shift of regulatory policy”
- Agreed with reordering of objectives from primacy on monopoly price control to recovering above normal profits
- Some modifications to objects clause and pricing principles
- Final response after Gas Code Review



**ELEMENTS: EPIC ENERGY
SUPREME COURT DECISION
(WASC, AUG 2002)**

- First and only judicial interpretation of either Code
 - likely to be equally relevant to electricity, as codes have same genesis (intent) and use same concepts, key words
- Leaving aside particularities of Epic case, decision focuses on general principles which have implications for regulation of utilities in general.
- Landmark case (like QCMA, Qld Wire) with Justices writing for history
 - deals extensively with ‘fundamental issues’ in clarifying law and guidance to regulators

EPIC IN-PRINCIPLE FINDINGS FOR REGULATORY APPROACH

- In essence, we believe these are:
 - the perfect competition approach to regulation is incorrect under the law; (perfect competition is foundation of building blocks, WACC approach)
 - the correct approach, as Hilmer and National Competition Policy intended, is the replication of the outcomes of workably competitive markets;
 - workable competition as understood by modern competition theory should be applied; and
 - take into account political and social considerations
- Minter Ellison (Oct 2002): *“The Court’s reasoning in this regard shows that the correct interpretation of the Code is vastly different from the narrow, theoretical approach which has been adopted by regulators to date.”*
- Professors Littlechild, Round: subs to QCA, Dec 2002

ELEMENTS: COAG (PARER) ENERGY MARKET REVIEW (DEC 2002)

- Recognised Epic implication of whether regulation should be aiming to replicate perfect or imperfect markets and potential for fundamental change in regulatory approach
- Recognised a number of debates (eg move to 'price monitoring', 'negotiate and arbitrate')
- Saw solution to concerns / debates in formation of a National Energy Regulator (replacing parts of the ACCC, state regulators, NECA) which would sort matters out
- 3 priority actions for electricity networks regulation:
 - price caps not revenue caps
 - incentives for defined service standards
 - certainty on sharing of gains and treatment of investments



ELEMENTS: GAS CODE REVIEW (POSSIBLE ToR)

- Build on PC Review on Access Regime, CoAG
- Examine cost, benefits of current regime, including on investment
- Examine minimum price and non-price requirements
- Ensure uniform application on a national basis
- Take into account recent legal decisions:
 - Epic Energy decision
 - Duke Eastern Gas Pipeline decision



WORKABLE COMPETITION: WHAT IS IT?

From WASC, characteristics can be reduced to:

- Provide choice and greater customer focus
- Provide incentives for innovation and investment
- Provide incentives for efficiency
- Provide flexibility in price and profit controls
- Restrain monopoly rents while permitting other rents

[ENERGEX submission to QCA, Dec 2002]

WORKABLE COMPETITION: WHAT IS IT?

- Professor Stephen Littlechild (father of incentive regulation, price cap):

“The Court’s reasoning must necessarily influence all Australian regulatory decision-making in future.”

“If competition is recognised as a process over time, instead of as an equilibrium state, then regulation has to replicate more of this competitive market process than it has done hitherto.”

“The Court said further that a workably competitive market might tolerate a degree of market power, even over a prolonged period.”

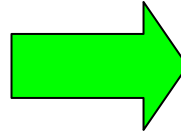
WORKABLE COMPETITION: WHAT IS IT?

- Professor David Round (Professor of Economics and Director of the Centre for Applied Economics, Member of the Australian Competition Tribunal and former Associate Commissioner of the ACCC):

“The hallmark of a workably competitive market is flexibility and independence in decision making, with no coercion, and freedom to choose on the part of both producers and consumers. This should be the implicit goal in theory of any regulatory scheme, but it is one that has in practice been subverted by a misguided application of perfect competition theory in the search for computational specificity and regulatory objectivity. What is needed is not a revenue cap based on cost of service provision, but flexible regulation that can adapt to market changes, encourage innovation, look after valid interests of consumers and producers, and above all to be relatively non-intrusive yet transparent.”

EVOLUTION OF REGULATION

COST OF SERVICE/ RATE OF RETURN



“TRUE” INCENTIVE REGULATION

REVENUE CAP	PRICE CAP RESIDUAL 'X'	HYBRID	US STYLE RATE OF RETURN
-------------	------------------------	--------	-------------------------

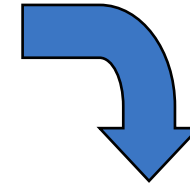
“HEAVY HANDED”

- Revenue/price control = profit control
- Does not emulate market signals
- Micromanagement
- Focus on forensic scrutiny of individual costs
- Low investment, service development
- No diversity of choice
- Higher prices long term
- Price shocks for customers or investors
- No abuse of market power

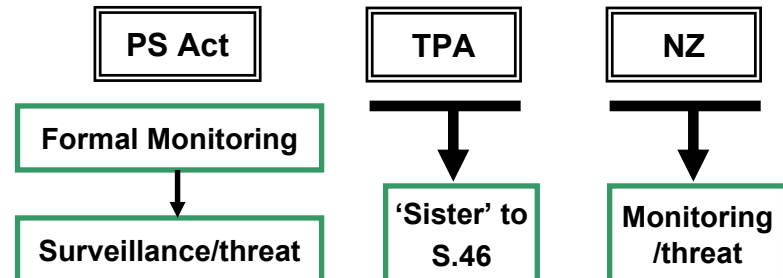
TFP	GLIDE PATH/TARGETS	PERFORMANCE BENCHMARKING (California)	“TRUE” PRICE CAP EXTERNAL 'X'	PRICE/SERVICE OFFERS
-----	--------------------	---------------------------------------	-------------------------------	----------------------

“LIGHT HANDED”

- Profits uncontrolled
- Emulates real markets
- Investment, innovation
- Focus on customers
- Diversity of new services
- Dynamic efficiency
- No abuse of market power



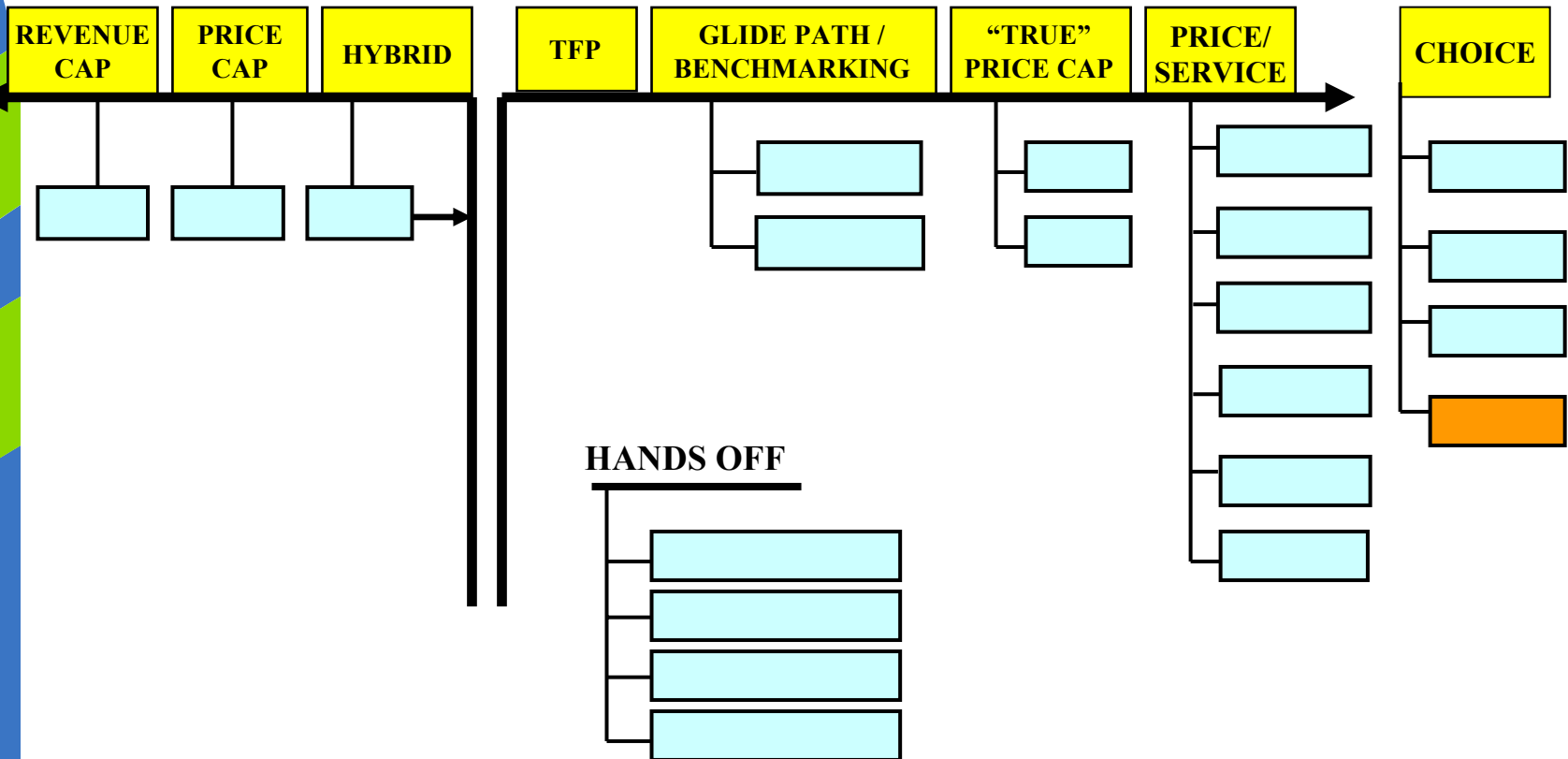
“HANDS OFF”



FORM OF REGULATION: INDUSTRY CHOICES (2002) - ELECTRICITY DISTRIBUTION COMPANIES AND AGA

COST OF SERVICE/
RATE OF RETURN

“TRUE” INCENTIVE REGULATION



PRICE-SERVICE OFFERINGS - WHAT IS IT?



- *Designed to emulate workable competition*
- *All about customer choice, with increasingly differentiated packages at agreed price*

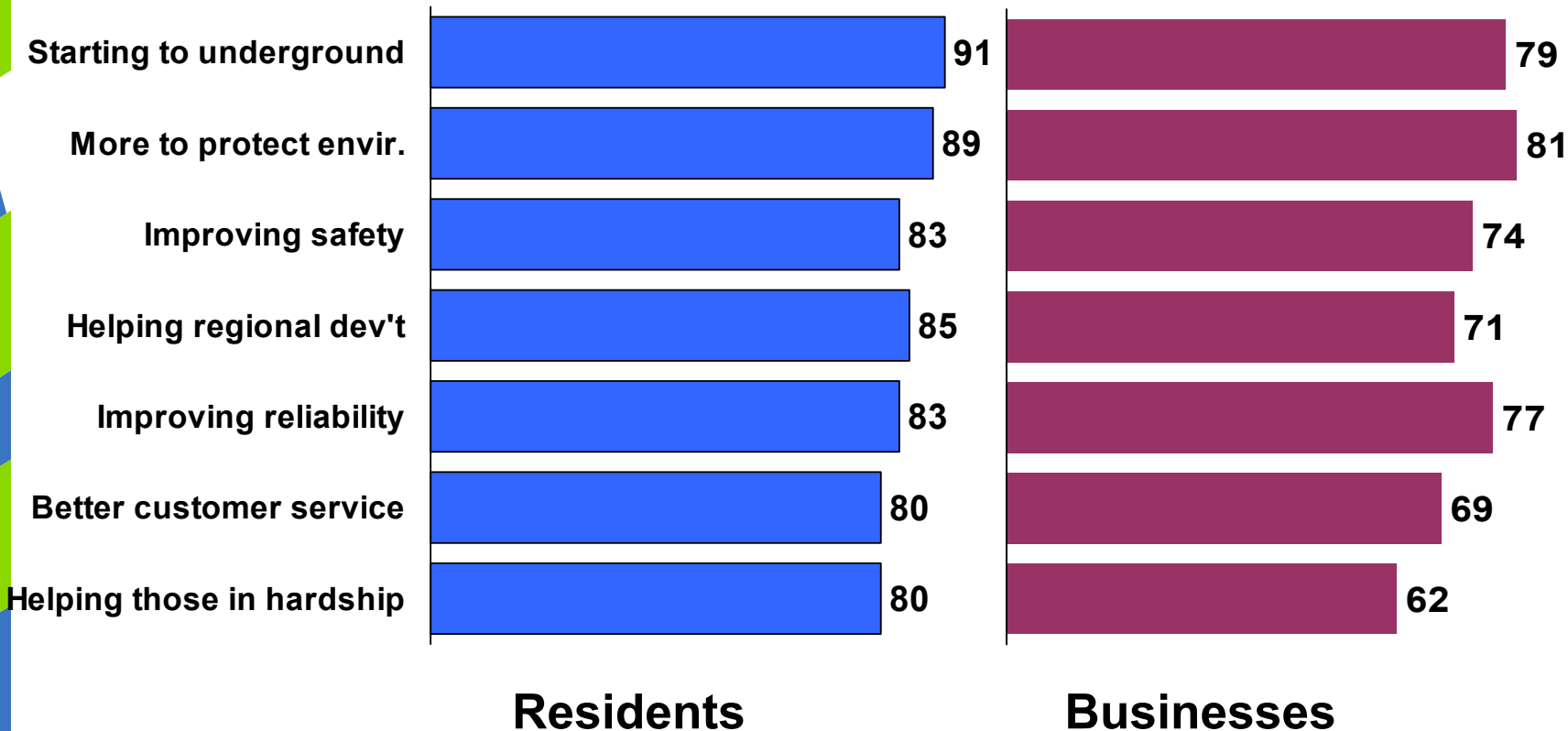


- *Tripartite regulatory contract*
- *Benchmarked services*
- *Tested by Regulator against objectives*



WHAT DO CUSTOMERS WANT?

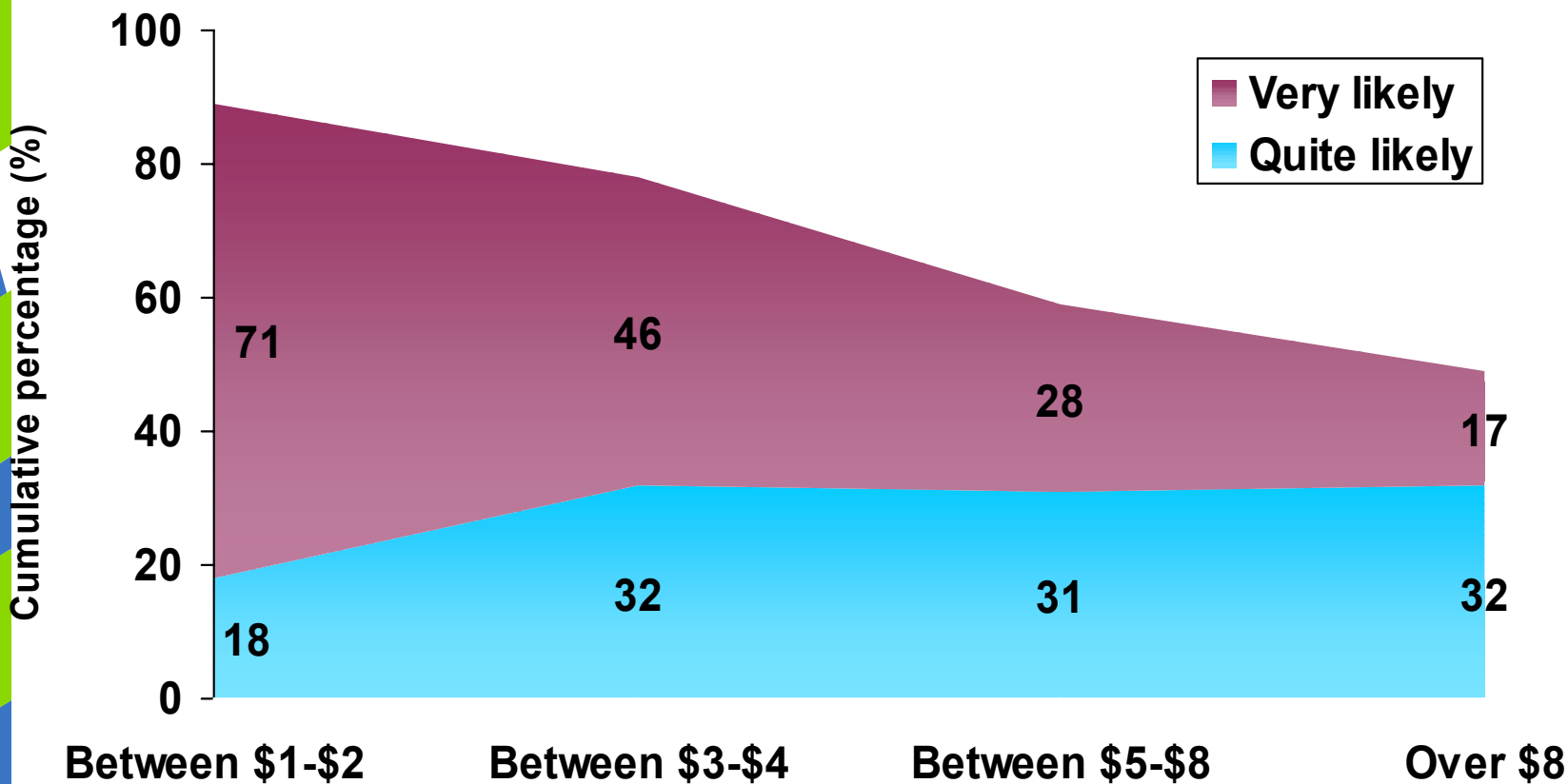
AC Nielsen Survey of ENERGEX Customers (2002)



Q1-7 With that in mind, I'm going to read out a number of services that ENERGEX is considering offering to the community in the future and I'd like you to tell me whether you do or don't support each one. In total there are seven services. PROMPTED

Base: All south east Queensland residents (n=604) and small/medium businesses (n=400)

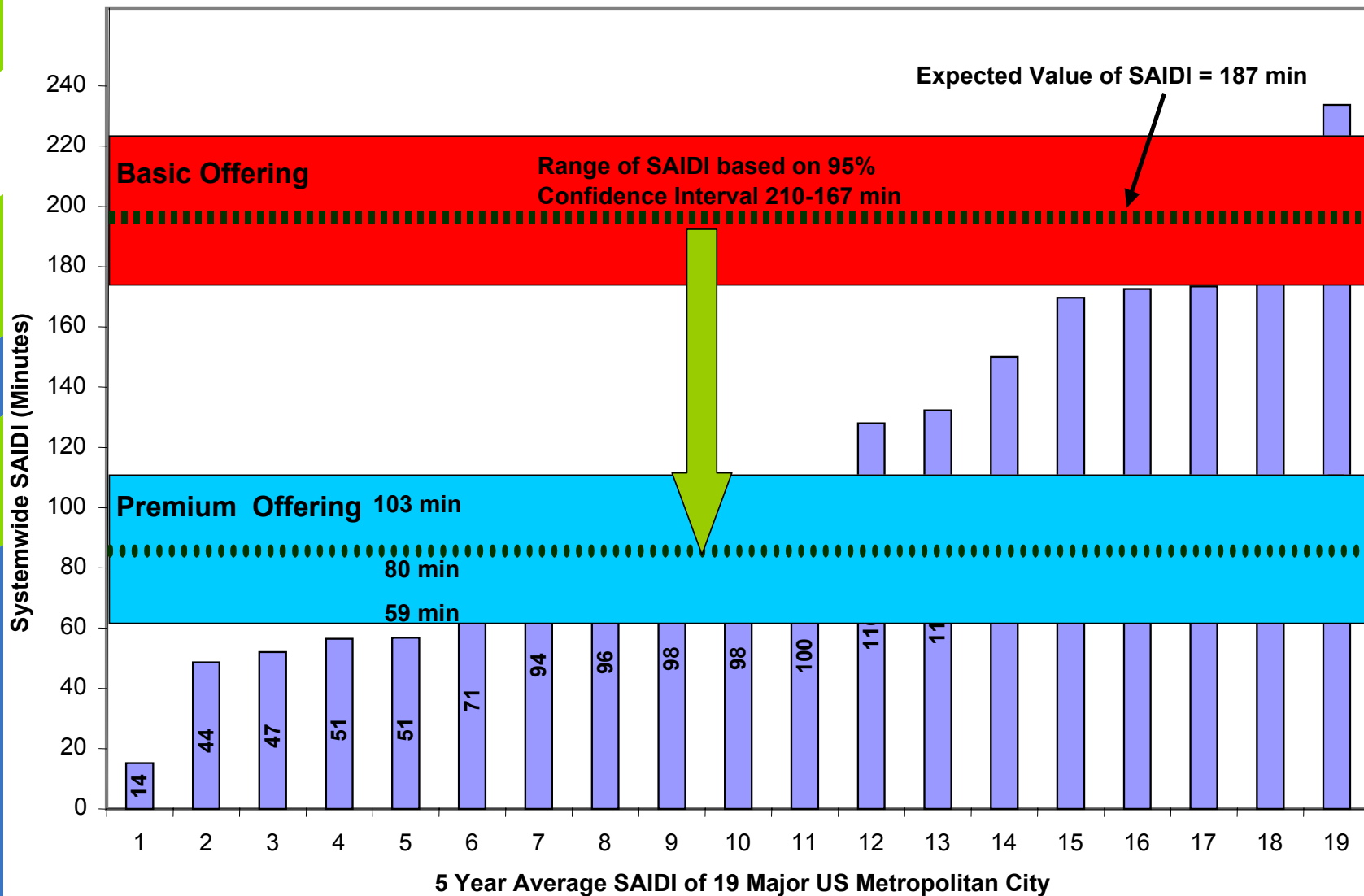
WHAT ARE CUSTOMERS WILLING TO PAY? AC Nielsen Survey of ENERGEX Customers



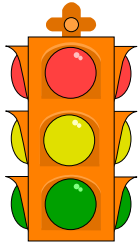
Total likely 89% 78% 59% 50%

Q9 Now thinking about all seven of these services, how likely would you be to pay <INSERT RESPONSE CODE> more per month if ENERGEX were to supply all of these services to your household? PROMPTED Over \$8, Between \$5 and \$8, Between \$3 and \$4, Between \$1 and \$2
Base: All south east Queensland residents (n=604)

PSO's: QUANTUM CHANGE IN SERVICE



ASSESSMENT OF REGULATORY REGIMES AGAINST WORKABLY COMPETITIVE MARKET CRITERIA



	Building Blocks	TFP	PSO	Monitoring/ Threat
1. Provide choice and customer focus				
2. Provide incentives for investment and innovation.				
3. Provide incentives for efficiency				
4. Provide flexibility in price and profit controls				
5. Restrain monopoly rents while permitting other rents				
6. Consistency with legal requirements <ul style="list-style-type: none"> ➤ CPI-X Rev (Price Cap under Codes) ➤ Process of competition 				

ASSESSMENT OF PSO's AGAINST WORKABLY COMPETITIVE CRITERIA

Professor Stephen Littlechild (Scherer: 16 criteria; Clark 3 Groups of objectives)

- *“...PSO seems more in tune with Clark’s own concept of the objectives of workable competition.”*
 - *PSO overcomes Clark’s criticism of the perfect competition model that it was “one-legged, focussing on the essentially static objective of price-cost equilibrium, to the neglect of the dynamic objectives of progress.”*
 - *“PSO seems to embody a greater possibility of meeting all of these different objectives. If successful, it could lead to greater diversity of outcomes, each more successfully meeting the objectives of those involved. Such diversity could, in turn, yield more scope for learning and benefiting from experience than the present system offers.”*
 - *“With these qualifications, price-service offerings substantially accords with developing thinking on the nature of competition, and could be practical, robust and feasible as a method for regulating energy networks. It deserves very serious consideration”*
- qualifications refer to identifying customer preferences and selection of customer representatives

PROFESSOR DAVID ROUND

- *“The regulatory approach that ENERGETX is proposing is quite consistent with modern theoretical, empirical and political thinking on the nature of competition and the type of goals the competitive process can achieve.”*
- *“I believe that the mandate exists in terms of review recommendations and source legislation, and indeed in occasional musings by some regulators, for behaviourally focussed approach that seeks to achieve market outcomes consistent with those obtainable in a workably competitive market. The PSO approach that is proposed by ENERGETX appears to be consistent with this philosophy.”*
- *“If ENERGETX can deliver what it promises, both the long run private as well as public net gains of a PSO approach to regulation could be impressive.”*

WAY FORWARD: AusCID

- Legislative change to:
 - insert objects clause for policy direction
 - specify regulatory framework in line of emulating the conditions of a competitive marketplace in line with the Epic decision
 - endorse price monitoring (amend Trade Practices Act provisions)
 - endorse price-service offerings
- Apply to transmission and distribution of both gas and electricity

WAY FORWARD: AGA FOR GAS

- Amend existing coverage test to more targeted approach
- Insert 'objects clause' to reduce regulatory discretion
- Insert new access pricing principles
- Provide for choice of alternative form of regulation by companies from expanded list, including:
 - price monitoring, price-service offerings, 'sharing of gains', TFP
 - 'sister' section to S.46
- Define treatment of efficiency gains
- Separate treatment of greenfield developments
- Fully effective merits review

WAY FORWARD: ESAA

- New regulatory ‘common rail gauge’ approach for distribution (notwithstanding national or local regulators)
- Legislative change to set:
 - set precise objectives for regulators
 - mechanism by which regulator operates, within defined limits
 - merits appeals
- Mechanism includes ‘propose/approve’ model:
 - companies and customer propose
 - regulator tests against objectives
- Review Gas Code with reforms emulating workable competition as set-up by WASC
- PC to recommend level of regulatory control required for operation of workable competitive market
- Review Electricity Code to operate like reformed Gas Code



WAY FORWARD: APIA

- Revise Gas code with aim of:
 - reducing scope for regulator discretion
 - improving incentives for investment
 - greater scope for commercially regulated outcomes

A COST OF SERVICE FUTURE?

