

# **INCENTIVE REGULATION**

## **Comments by Denis Lawrence**

- **Regulatory objectives**
- **Three main types of regulation**
- **The regulator's dilemma**
- **Efficiency levels vs growth rates**
- **Comparing like with like**
- **Conclusions**

# REGULATORY OBJECTIVES

- **Pre-microreform networks characterised by gold-plating and overstaffing – reliable but unresponsive**
- **Aim of reform was to make networks efficient but reliable**
- **Mimicking competitive markets seen as way of achieving this**
- **Regulation by price caps (CPI-X):**
  - **industry average price prevails;**
  - **not based solely on own costs;**
  - **response to efficiency and other changes gradual**

# THREE TYPES OF REGULATION

## Cost of service regulation

- Low power, low risk, mediocrity encouraged
- Information asymmetries, high regulatory costs

## Incentive building block regulation

- Medium power and risk, still focuses on own costs
- Risk of regulator micromanaging, may distort capital/O&M choice, high regulatory costs

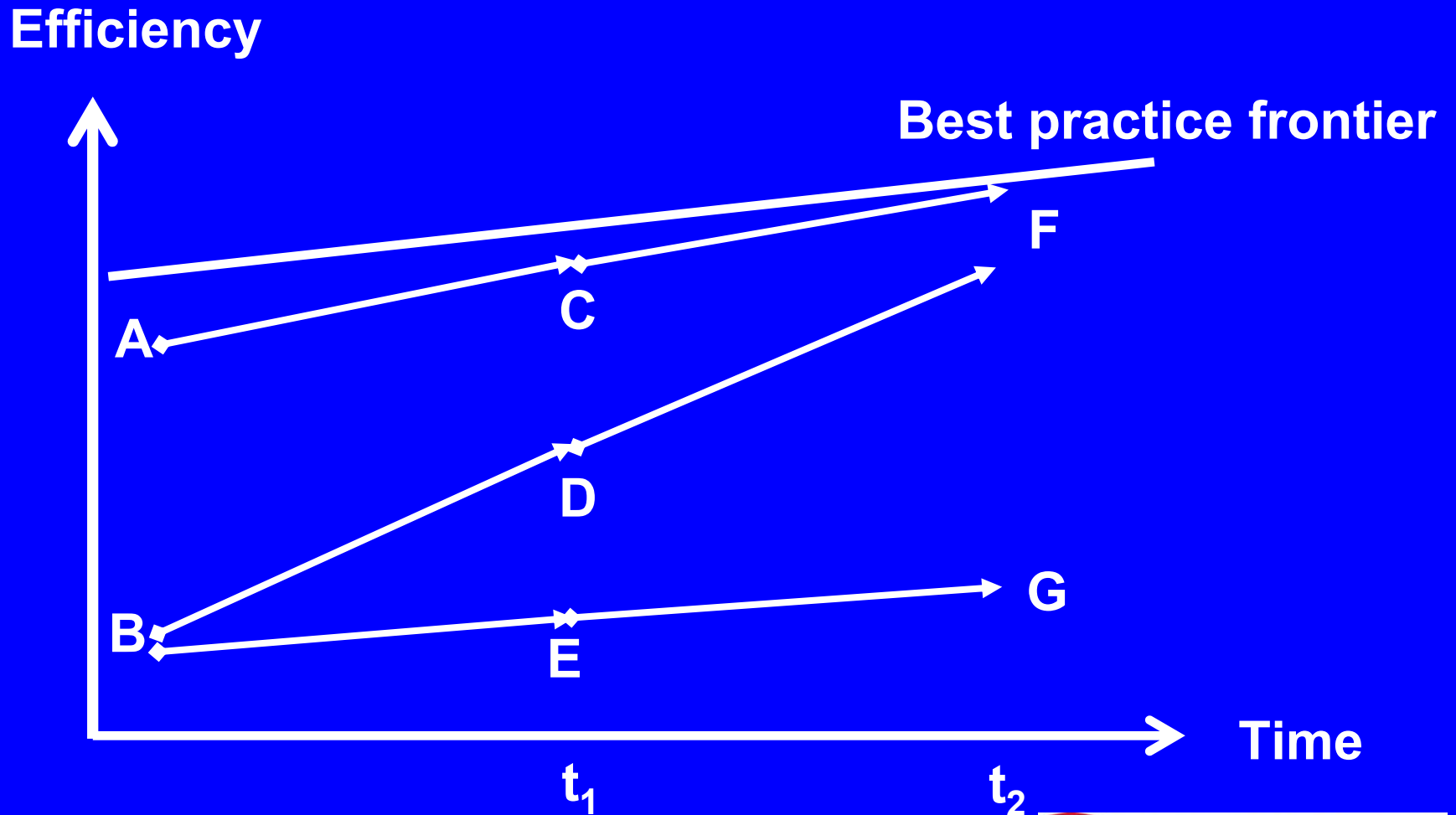
## Incentive index-based regulation

- High power but also high risk (under or over earning)
- Innovation encouraged, less scope to 'game' system
- Delinks prices and own costs, low regulatory costs

# THE REGULATOR'S DILEMMA

- Most acknowledge desirability of moving to the index-based approach and delinking from costs
- But most are concerned about inherent risks – high costs from failure of an essential service
- Is the regulatory system sufficiently mature?
- Are the utilities sufficiently mature?
- Hybrid approaches: greater use within building block framework versus adopting safeguards
- Are ESMs and off-ramps worthwhile or are they defeating the purpose?
- Efficiency levels versus growth rates

# EFFICIENCY LEVELS & GROWTH RATES



# LEVELS VERSUS GROWTH RATES (2)

- Index approach can be mechanistic when firms starting from similar points
- Rolling X factor particularly attractive
- When there is a wide spread of efficiency levels will need to include 'stretch factors' (+ve for laggards, possibly -ve for leaders) as well as industry average
- Will involve judgments about what is a reasonable starting point and how quickly gaps can be eliminated
- Will take some time to get to the point where the index approach can be applied mechanistically

# COMPARING LIKE WITH LIKE

- ➡ **What is the appropriate industry average?**
- ➡ **Wide range of operating environments in Australia but relatively few utilities**
- ➡ **High density CBD, urban, rural and remote**
- ➡ **Particular problem for levels exercise but will also affect growth rates comparisons**
- ➡ **Split sample urban/rural**
- ➡ **Broadbanding**
- ➡ **Supplement with overseas data?**

# CONCLUSIONS & ISSUES

- ➡ **Index-based approach is clearly the desirable way to go**
- ➡ **Are regulators and utilities ready?**
- ➡ **Does the approach have to be uniform?**
- ➡ **What are sensible risk-mitigating strategies?**
- ➡ **What are sensible comparators and how should these evolve over time?**