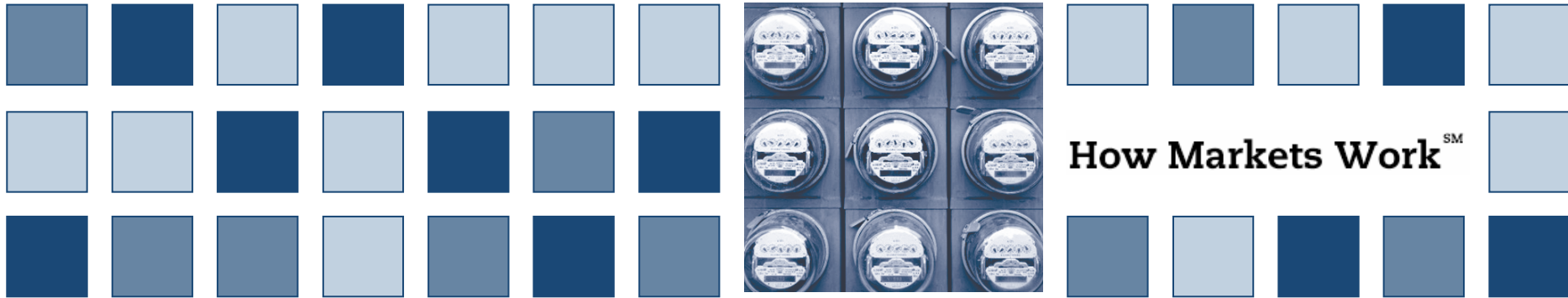


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How Markets WorkSM

Incentive Regulation and Implementation To Index, or Not to Index? – Optimising the Trade-off

Greg Houston, Director, NERA
ACCC Seminar, Melbourne
8 May 2003



Optimising the Trade-off

Taking Account of the Industry Context

- **For pipes and wires businesses, typically, two thirds of costs are capital-related**
 - see, for example, the Welsh water utility, Glas Cwmyru
- **Reducing the price investors require to finance existing and new capital is the largest source of potential efficiency**
- **Reducing unnecessary regulatory risks should be the single most important priority**





Mechanisms to Reduce Regulatory Risk

- Reducing regulatory risk involves increasing
 - Transparency
 - Predictability
 - Replicability
- “the most important element of the system is the restraint of arbitrary administrative action” – Levy and Spiller (1994)
- Index based approaches can and should contribute to this goal
- But there is no ‘silver bullet’.....



Critical Elements of an Index Based Approach

- **Initial prices that are based on firm specific costs**
- **A settled methodology for deriving the index**
- **A well-specified basis for adjusting the index in light of new information ,eg, off ramps, changes in industry cost, etc**
- **A well-specified basis for deciding whether/when/how to update initial prices, and the index itself**

- **To the extent these elements are not present**
 - **Investors face unnecessary risks**
 - **Customers face unnecessary costs**





Critical Elements of a Building Block Approach

- Initial prices that are based on firm specific costs
- A basis for projecting costs that minimises regulatory judgement, eg, reported actuals plus PFP indices
- Fixed term price cap with the basis for any re-openers well specified beforehand
- A well-specified basis for measuring and sharing efficiency gains across price cap periods

- To the extent these elements are not present
 - Investors again face unnecessary risks
 - Customers again face unnecessary costs





Critical Foundations for both Approaches

- The basic ingredient underpinning each set of requirements is identical

“Consistent, robust, financial and service performance information, collected on an industry-wide basis, over a long period”

- Such information underpins
 - Starting prices, or P_0
 - Derivation of TFP or PFP indices to project cost trends



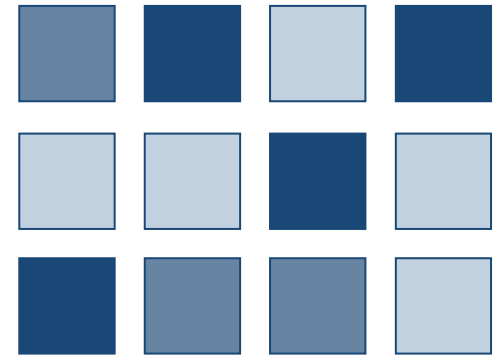


Critical Foundations for both Approaches

- A NERA colleague describes the US Uniform System of Accounts as a “national treasure”

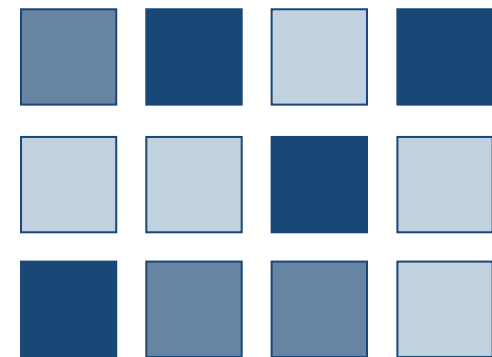
“This rarely leaves US Energy Utilities and their regulators in major dispute over financial issues (like profitability, depreciation expenses, customer contribution, the admissability of particular costs or the treatment of unregulated affiliates)” Malkholm (1999)

- The development of a nation-wide accounting and service performance reporting framework in Australia is decades behind other jurisdictions, eg, US, UK, NZ
- Making serious progress on this issue is the key to
 - Making practical progress towards TFP based approaches
 - Reducing the angst and risks associated with building blocks



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