

SUBMISSION TO UTILITY REGULATORS' FORUM FARRIER SWIER REPORT ON COMPARISON OF BUILDING BLOCKS AND INDEX-BASED APPROACHES

Overview

ENERGEX is of the view that an evolutionary step change in the form of regulation being applied is vital to ensuring utilities operate in future with appropriate incentives and to create dynamically efficient markets. To this end, ENERGEX commends the Utility Regulators' Forum (URF) on the commissioning of the Farrier Swier study and on the consultative process now underway in relation to the study.

However, ENERGEX believes that the scope of the study is unduly limited and arguably already outdated. The evolution of regulatory thought has progressed significantly in recent times, with a range of regulatory models under active consideration at the national level (see Attachment 1). Such models include price caps based on external benchmarks, performance benchmarking, franchise bidding, price-service offerings and price monitoring. Various other reviews, such as the recently released Productivity Commission Review of the National Access Regime, the COAG Energy Market Review, the Dawson Trade Practices Act Review and the mooted Gas Code Review, as well as the recent Supreme Court decision on the Epic Energy gas transmission pipeline, have canvassed elements of such second generation, lighter-handed forms of regulatory models. In particular, the Epic decision potentially questions the legality of each of the four options canvassed in the paper, suggesting that regulators urgently need to widen the scope of reform options in addressing the imperative for change in the regulatory framework.

In this light, the Farrier Swier study can be considered at best a partial examination of the pertinent issues regarding the future of regulation. This submission outlines some of the further issues that are worthy of exploration by the URF as well as providing some general comments on the content of the study.

General issues in improving regulatory models

The problems with the current building blocks approach to regulation are well documented. In particular, it encourages a strong focus on cutting costs and managing inputs in the provision of services. However, it creates few or no incentives in relation to the business's outputs or outcomes in terms of service delivery, such as:

- investing in and developing the market (investment);
- producing innovative new products and services (innovation) in order to meet changing requirements over time (dynamic efficiency); or
- understanding and working to meet the needs of customers (customer focus).

These are significant deficiencies in the application of regulation under the current model. Support for these views is found in the Productivity Commission's Review of the National Access Regime, which states for example in relation to the effects of regulation on investment:

Access regulation can intrude significantly on property rights and give rise to a range of costs that must be set against its benefits. These include ... reduced incentives to invest in facilities to provide new essential services ... (pp. xvii-xix)

The original 1993 Hilmer report on National Competition Policy, which was the catalyst for the creation of the National Competition Policy and associated changes to the Trade Practices Act to introduce the national access regime, also supports the proposition that dynamic efficiency and innovation are important in the development of such a policy:

Efficiency is a fundamental objective of competition policy because of the role it plays in enhancing community welfare. There are three components of economic efficiency ... Dynamic efficiency reflects the need for industries to make timely changes to technology and products in response to changes in consumer tastes and in productive opportunities. Competition in markets for goods and services provides incentives to undertake research and development, effect innovation in product design, reform management structures and strategies and create new products and production processes. (pp 3-4)

Appropriate access prices may depend on factors such as the extent the facility's existing capacity is being used, firmly planned future utilisation and the extent to which the capital costs of producing the facility have already been recovered. Decisions in this area also need to take account of the impact of prices on the incentives to produce and maintain facilities and the important signalling effect of higher returns in encouraging technical innovation. (p 253)

The recent decision of the WA Supreme Court on the decision of the WA regulator in regard to the Epic gas transmission pipeline adds further weight to the argument that the application of cost of service regulation has inadequately considered the need to maintain investment in regulated assets:

If future investment in significant infrastructure, such as a natural gas pipeline, is to be maintained and encouraged, as the public interest requires, regard seems to be required to the need for both existing and potential investors to have confidence that the very substantial long term investment decisions which are required, and which were sound when judged by the commercial circumstances existing at the time of the investment, are not rendered loss-making, or do not result in liquidation, by virtue of future governmental intervention. (cl 149)

Indeed the expert evidence, including the supportive expert writings, suggested a growing awareness of the long term disadvantages of striking the balance with too great an emphasis on the interest of consumers in securing lower prices, and without due regard to the interest of the service provider in recovering both higher prices and its investment. (cl 145)

It also supports the view that in considering economic efficiency, regulators should have regard to dynamic efficiency as well as productive and allocative efficiencies:

The evidence establishes, notwithstanding some differences of detail, that according to the theory of economic efficiency, the concept of efficiency has at least three well recognised dimensions. These are, productive efficiency, allocative efficiency and dynamic efficiency... (cl 115) From what has been discussed already the conclusion commends itself that the phrase "economically efficient", used in s 2.24(d) and 8.10(h) of the Code for example, was intended to reflect the concept of economic efficiency discussed above. (cl 120)

On the issue of greater customer focus, some regulators have introduced mechanisms to gain a better understanding of the needs of customers. For example,

the Essential Services Commission in Victoria noted in its 2000 electricity Determination that:

In June 1999, the Office invited the distributors to propose a set of base-case service targets to apply for the period 2001-05, as well as alternative, higher levels of service performance, where they believed this reflected customer preferences and their willingness to pay. The Office also asked distributors to specify the cost and tariff impacts of any improvement proposals to enable customers to consider the choices and relevant trade-offs. ... This approach was consistent with customer surveys and comments received in the course of the Office's own consultation process that have highlighted the importance to customers of improving reliability, particularly in those regional areas where service has been relatively poor. Customers also indicated that they were generally prepared to sacrifice some of the potential price reductions arising from the review, in exchange for tangible improvements in reliability. (pp xvi-xvii)

However, the involvement of customers in regulatory determinations has usually been very limited.

Given these flaws in the current cost of service regime, any reform of the regime should be considered in light of the need to address these shortcomings.

The proposed TFP approach articulated in the Farrier Swier report appears to continue the cost of service focus on costs or inputs, while doing little to address the issue of incentives regarding outputs and outcomes (ie. investment, innovation, customer focus and dynamic efficiency). While the proposed approach has the benefit of linking prices to industry productivity gains, providing the possibility of reward where performance exceeds the industry benchmark, this represents only a small step toward remedying the deficiencies under the current regime.

ENERGEX suggests that the Farrier Swier report is an ideal starting point to undertake a further, wide ranging review of the problems encountered under cost of service regulation, and an analysis of the costs and benefits of various other regulatory frameworks across the spectrum of possible options. ENERGEX urges the Utility Regulators' Forum to consider such a review.

Specific response to matters raised in the report

The Farrier Swier report suggests (p 9) that in practice, the application of a TFP regime along the lines proposed may produce outcomes very similar to the current cost of service approach. This view appears to be supported by the ORG quote (p 9). ENERGEX supports this view, given that the TFP model put forward by Farrier Swier is linked to a cost service approach. As such there would be little difference in practice between the two regimes.

ENERGEX contends that a true TFP model would not be linked to costs. As Farrier Swier notes (p 17), ideally, CPI-X regulation would aim to delink the prices set for an individual firm from its own costs. ENERGEX supports this view, and considers that a true TFP model, linking prices to industry productivity without micro-scrutiny of a firm's individual costs, provides for greater benefits than the Farrier Swier approach.

ENERGEX disagrees with Farrier Swier's comment that it would not seem possible to disregard actual costs in the long term for political and financial sustainability reasons. Neither of these constitutes an objective of an independent regulator – indeed if the aim is to replicate market outcomes, then it is inappropriate for

regulators to aim to achieve financial sustainability for a regulated entity. This does not detract from the need to ensure regulation adequately reflects the risks involved in a particular market.

ENERGEX notes the following statement made by Farrier Swier:

This discussion paper is primarily focused on the application of price caps to sectors that are considered to have a strong ongoing degree of monopoly power into the future. This is likely to cover the bulk of existing assets and a significant level of new capital investment in the foreseeable future. (p 10)

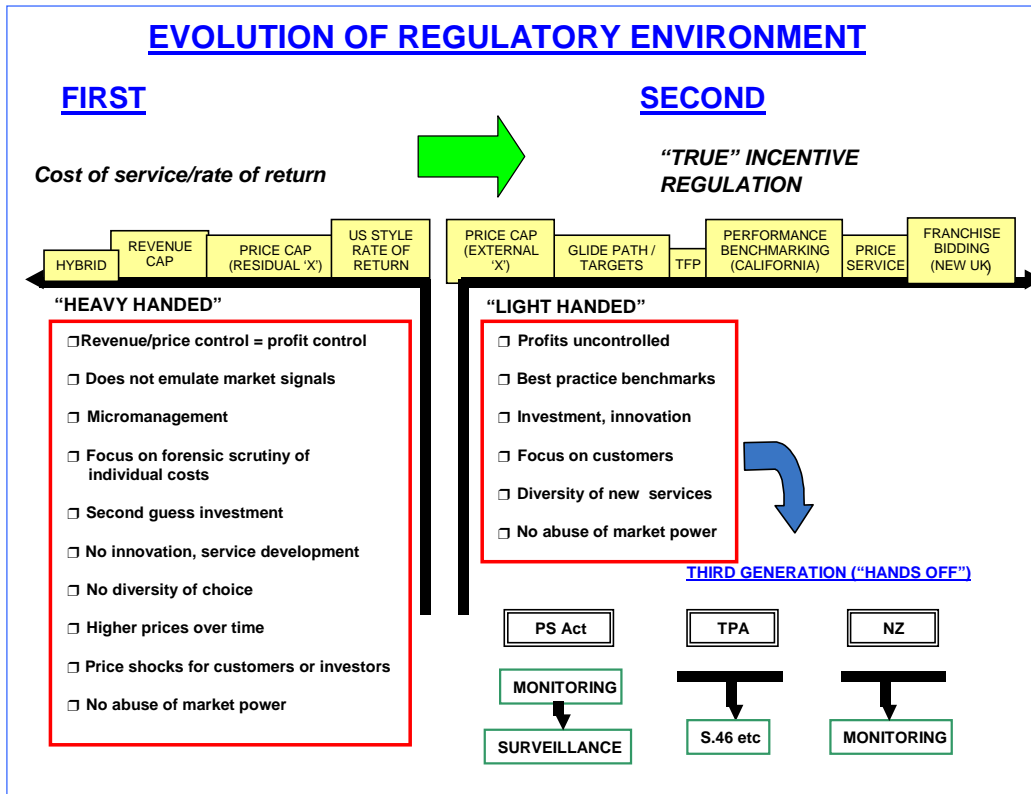
ENERGEX considers that Farrier Swier has presented no evidence to support this statement. In fact, an increasing proportion of expenditure by energy companies is in relation to the non-regulated or contestable elements of these businesses, with a growing number of customised contracts for network services being negotiated outside of regulatory arrangements. Such developments indicate that the cost of service approach to regulation will become progressively more difficult to implement over time, and suggest an alternative and more flexible approach is both warranted and increasingly necessary.

Farrier Swier note (p 14-15) that there are two schools of thought as to how price regulation should evolve: retain the building blocks approach and change the way it is applied, or adopt an approach based on TFP regulation. This is incorrect – the regulated companies each have different views and have in the past offered support for a range of different regulatory models (see Attachment 2). Indeed ENERGEX made a submission to Farrier Swier outlining these different views as part of the review process, which is not reflected in these comments. The Farrier Swier statement in this regard is overly simplistic in attempting to narrow the current national debate to fit the terms of their review.

Farrier Swier comment (p 61) that they are unaware of any clear empirical evidence that demonstrates that any of the TFP or building block approaches are clearly more effective than another in encouraging dynamic and productive efficiency. However the question raised is not one of relativity between the approaches discussed, but in relation to evidence that such cost-based regulatory approaches stimulate these efficiencies at all. In ENERGEX's view, this is an area that requires considerably more attention than has been afforded by this study.

Conclusion

ENERGEX welcomes the initiative of the URF in developing options for reforming the regulatory framework under the current Electricity and Gas Codes, given the well recognised deficiencies inherent in current cost-based forms of regulation. While the Farrier Swier study provides a starting point for consideration of these issues, in light of the ongoing national debate and the questions posed over the legality of building blocks and cost-based forms of regulation by the Epic decision, further work needs to be done to identify and explore other options for reform of the regulatory framework that will address the full scope of the issues under discussion. ENERGEX would be pleased to participate in any further review.



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HYBRID

REVENUE CAP

PRICE CAP (RESIDUAL 'X')

US STYLE RATE OF RETURN

PRICE CAP (EXTERNAL 'X')

GLIDE PATH / TARGETS

TFP

PERFORMANCE BENCHMARKING (CALIFORNIA)

PRICE SERVICE

FRANCHISE BIDDING (NEW UK)