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Dear Eric

Re : Comparisons of Building Blocks and Index Based Approaches

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit legal centre based in Sydney. PIAC has established the Utility Consumers' Advocacy Program (UCAP) with funding from the NSW Government. A community based Reference Group supports the development of policy by UCAP.

The following comments are submitted to the National Regulators Forum in response to the discussion paper produced by Farrier Swire Consulting. In considering the issues raised in the paper we have focussed on the regulation of natural monopoly networks in the electricity, gas and water industries.

Farrier Swire Consulting have described the conditions under which they consider it is appropriate for regulators to use building block approaches to network revenue regulation. In our view that description provides a very good fit with the conditions under which the network businesses in these industries are operating at present in New South Wales. This perhaps leaves aside the specific case of network access pricing.

We note that the consultants have suggested that the building blocks approach can have a tendency to replicate many aspects of 'rate of return' regulation. It will come as no surprise for PIAC to argue that, at least in New South Wales, the regulator should continue to give consideration in its network revenue determinations to the appropriate rate of return earned in the electricity, gas and water industries.

PIAC questions whether at least some of the support from within the industries for a move towards a cost-index approach is directed at this issue of rates of return. It is of concern that some industry participants may see the cost-index approach as an opportunity to sidestep the curent restrictions on WACC and rates of return by boosting their revenue relative to costs. In essence, we remain sceptical that the preference for light handed regulation is derived from a desire to boost profitability while reducing the accountability of these monopolies.

Our understanding is that the building blocks approach currently used by the Independent Pricing and Regulatory Tribunal offers a more certain regulatory outcome to the community, not least the end-users of these network services. One of PIAC's concerns with regulation of utility network businesses is that the assessment of costs generally is highly subjective. As a result many stakeholders have expressed concerns about the extent to which this regulatory method is being gamed. On the other hand, the Farrier Swire Consulting report has not convinced us that cost-indexed approaches, and 'total factor productivity' in particular, would suffer these weaknesses to a lesser degree.

The consultants have looked to the Victorian Essential Services Commission for an example of what they describe as an evolution of the building block approach. In that case, we are told, a cost-indexed approach has been applied to the OPEX component of the building blocks. This does not answer the question as to why there should be less confidence in the accuracy of the forecasts of costs provided by the building block approach. It appears that the cost-index approach cannot provide the sane level of accuracy. Indeed, the consultants have pointed to the difficulty of aligning costs and revenue in the short term at least.

This raises the question of how the cost-index approach can identify and deal with over-recovery. Would a regulator using the cost-index approach be committed from the outset to identifying over-recovered revenue and returning it to end-users, perhaps in a later regulatory period?

Our greater concern, however, is that one of the chief advantages claimed for cost-index approaches may have been overstated. The transformation of building block regulation is argued to retain incentives to monopoly network businesses to drive greater efficiencies and lower costs. Yet, it is our understanding the shift to an indexed measurement of costs would have the effect of dampening these incentives. Where a regulator has acted prudently in relation to the commercial viability of network firms it may be that historical allowances for costs are conservatively high. If this leads to an additional buffer being built into a cost-index then surely there are reduced incentives for firms to reduce their own costs. Those firms already operating below the index would appear to have an incentive to permit their costs to rise over time.

The other key argument raised in support of indexed approaches is that they involve less intrusive regulation. Clearly it will not be less costly regulation, certainly not in the short term. The consultants have cited the concerns of the Productivity Commission at the increased costs incurred by a move to indexed-based approaches. Whatever the criticisms of the building blocks approach it is a method which now has undergone considerable development. Yet, the case studies cited by the consultants indicate that there is little reliable information as to the actual benefits of cost-index approaches. To our mind this does not suggest that moving to greater use of cost-indexed methods of revenue determination would be efficient or effective.

In conclusion, we wish to respond to the comments made by the consultants with respect to the financial viability of the regulated businesses. We accept there is a need to select a regulatory model which does not build commercial risks into an industry. However, our view is that there is no reason to suggest that greater risks have been imposed as a result of the regulatory decisions made in Australia in recent times. Further, we note that while there have been predictions about the impact of individual decisions on the behaviour of investors there has been no capital strike in relation to electricity and gas networks. Equally, there appears to have been no shortage of buyers for network business whether held in private or public hands.

We do not believe that Australian regulators would permit a situation where a regulated network business became financially unviable. Certainly, should circumstances ever arise where the viability of a firm or an industry was in question PIAC would support a decision to revisit the relevant regulatory decisions.

Yours sincerely
Public Interest Advocacy Centre

Jim Wellsmore
Policy Officer