



31 March 2006

Manager, MCE Secretariat
Department of Industry, Tourism and Resources
GPO Box 9839
Canberra ACT 2601

REVIEW OF REVENUE AND NETWORK PRICING ACROSS THE ENERGY MARKET

Attached is the Essential Services Commission's response to the Draft Report to the Ministerial Council of Energy by the Expert Panel on Energy Access Pricing.

In responding to the Draft Report, the Commission has focussed its attention on the Panel's comments and conclusions in Chapter 6 of the Draft Report 'Guidance on the Application of Price Control'. In particular, the Commission has focussed on the Panel's comments in relation to the application of Total Factor Productivity-based approaches to regulation.

In most respects, the Commission supports the views and conclusions of the majority Expert Panel in its Draft Report and recognises the careful analysis that is provided to support these conclusions.

In particular, the Commission agrees that there are important differences between energy sectors that have implications for both the form of and need for access regulation. In this regard, the Panel has appropriately identified the importance of determining coverage as a way of resolving many of the tensions between competing policy objectives, including the adequacy of returns and the risk of under-investment.

The Commission also agrees with the Panel's observations in respect of the problems associated with creating a legal presumption in favour of a regulator accepting a regulated business's proposal and the use of 'plausible' ranges for price determination parameters.

The Commission notes the Panel's recommendation that it is desirable to provide for carefully specified merits based reviews of decisions made by the AER.

A regulator has to satisfy certain statutory objectives that include encouraging economic efficiency (including efficient investment), ensuring that customers benefit from efficiency gains, providing certainty and minimising regulatory costs. Currently, price reviews are conducted so that there is sufficient time and resources for regulators to appropriately consult with stakeholders — both distributors and consumer groups — in order to determine an appropriate balance between these often conflicting objectives.

The Commission believes that the appropriate view of the role of the merit appeal system is contained in the landmark Hope Case:

Under the statutory standard of just and reasonable, it is the result reached, not the method employed, which is controlling ... It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial enquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important. Moreover, the Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgement which carries a presumption of validity. And he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.

In addition to these views, the introduction of a low threshold merits-based review would place the merit review panel in the position of the regulator and duplicate the role that the regulator plays in balancing the objectives of regulation. In effect, the panel becomes the regulator raising an issue over what role the regulator then plays. This role would need to be clarified to ensure that there is minimal duplication and thus proper accountabilities established.

More importantly, merits-based reviews may not result in a balanced representation of all stakeholders views. Commonly, appeals against price determinations involve the distributor (the usual appellant) and the regulator. While customer representatives may bring their own appeals against a determination or even where they may participate in appeals processes, they commonly do not have the resources to enable them to take such action.

In relation to information gathering, the Commission agrees that access to the underlying cost information is a crucial foundation for all forms of price cap regulation. Information gathering powers for regulated businesses, their associates and related parties including major service providers should also include the requirement to collect and report relevant information.

However, the Commission notes that the form of regulation has important implications for the incentives on businesses to mis-report and pursue corporate structures that may mask company cost and return performance.

For this and other reasons, the Commission strongly supports the Panel's broad acceptance of TFP-based approaches as a worthwhile development for electricity and gas distribution businesses. It also supports the Panel's recommendation for the National Electricity and Gas Laws to direct the Australian Energy Market Commission to review and develop Rules that permit the economic regulation of distribution and transmission services through the application of a TFP-based approach.

However, the Panel raised a number of issues that it believes need to be resolved before TFP-based regulation can be accepted as a preferable alternative to the building blocks framework.

The Commission has undertaken extensive research of the application of TFP-based regulation. Most recently, the Commission, with the assistance of Pacific Economics Group, has been considering issues associated with the design, implementation and transition to a TFP-based approach. This work addresses the issues identified by the Panel and the results are set out in the attached report, 'Transitional and Implementation Issues in Total Factor Productivity Regulation'.

The Commission also draws the Panel's attention to the Commission's previous work on TFP-based approaches. This previous work (undertaken by Pacific Economics Group) has estimated a TFP trend for the five Victorian electricity distribution businesses and developed an economic simulation model that demonstrated the incentive power created by different regulatory regimes. The reports resulting from this work are available on the Commission's website at www.esc.vic.gov.au.

This body of work and, in particular, the attached report provides a solid base for the AEMC's future work on TFP should the Ministerial Council accept the Panel's recommendations.

The Commission would like to take this opportunity to comment on some other aspects of the Draft Report as they relate to TFP. While supportive of the Panel's conclusions in most instances, the Commission would like to note the following.

Sharing of efficiency gains

The Panel's report emphasises the importance of the efficiency incentives created by different regulatory regimes but under-emphasises the importance of how the benefits of the efficiency gains achieved are shared between customers and shareholders.

Under any regulatory approach, regulated firms have incentives to retain the benefits of achieved efficiencies rather than pass these through to customers in the form of lower prices. Firms can undertake many actions to prevent efficiency gains from being reported. Examples include re-allocating common costs and adopting complex corporate structures that obscure the efficient cost of regulated service provision.

Hence, the relative merits of one regulatory approach over another depends not only on the strength of the incentives to achieve efficiencies, but also on the extent to which one approach ensures a fair sharing of the efficiency gains over another approach.

Pacific Economics Group's incentive power work for the Commission demonstrated that TFP-based approaches to regulation can create stronger incentives for efficiency and, more importantly, provide more benefits to customers than the building blocks approach.

References to 'steady-state' utilities

In its discussion on TFP, the Panel makes reference to 'steady-state' utilities. Some regulators and companies may interpret this commentary to mean that TFP is only relevant in situations where there are no substantial changes occurring in the industry.

As the attached report sets out, TFP-based approaches can accommodate situations where substantial change is occurring within an industry and where long-term cost or demand pressures differ between an individual firm and the industry as a whole. The latter phenomenon can be dealt with largely in the establishment of start prices. A 'rolling X-factor' that is adjusted for changes in industry TFP is also an effective means of accommodating industry-wide changes in costs or demand.

Any queries on this submission or the attached report should be directed to the Commission's Chief Executive Officer Paul Fearon on (03) 9651 0211.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Greg Wilson', written in a cursive style.

GREG WILSON
Chairperson