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By email: michael_seery@ipart.nsw.gov.au

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Dear Michael

Re : Review of the form of network price regulation

This letter provides our comments in response to the Tribunal's discussion paper *Form of Economic Regulation for NSW Electricity Network Charges*. I trust these will be of assistance to the Tribunal and the Secretariat in progressing the review. We look forward to further opportunities to discuss the many issues raised in this review.

The Options

The Tribunal's discussion paper has provided a brief discussion of four options for the form of regulation which might be adopted for future regulatory periods. However, the issues raised for the Tribunal by this review go beyond the difficulties of selecting between these four, sometimes closely related, models. The timing of this review raises the possibility that with the commencement of the forthcoming regulatory period stakeholders in the NSW electricity industry will be operating with, effectively, a third regulatory model in four years. It must be acknowledged that this places some limits on the Tribunal in weighing up the advantages of the four models. In our view, the over-riding principle of certainty suggests that the NSW industry can be moved away from either a pure revenue cap model, or even the predecessor hybrid revenue cap, only where there are overwhelming advantages or compelling reasons for doing so.

This would appear to discount the possibility that the eventual decision will embrace a 'basket of prices' approach to the setting of revenues. This approach has previously been canvassed in relation to the pricing of water and sewerage services by the NSW metropolitan water service agencies. To date, the Tribunal has not adopted such an approach in either the water or electricity industries. However, PIAC believes that both the weighted average price cap and the revenue yield price cap methods of regulation deserve further consideration.

In particular, PIAC is interested in each of these models because it appears that they have the effect of producing some transparency in the pricing decisions made by the distribution businesses in respect of different classes of customers. The debate over the extent to which business and residential customers each are subsidising the other, although based on limited and uncertain evidence, has raised the possibility that households may yet see pressure for increased prices. In saying this, we note that the current approach to regulating retail prices for small consumers has proven resilient to demands for change. Yet, the Tribunal's decision to endorse the approach of a 'subsidy free zone' for distribution prices (in its decision on *Pricing Principles and Methodologies*, March 2001) suggests that these challenges have not yet been exhausted.

In continuing to support some measure of price regulation we are mindful of the contest between the advocates of this form of regulation and those who favour revenue regulation. We note, too, that the Victorian Supreme Court has in a recent decision (*TXU Electricity v Office of the Regulator-General [2001] VSC 153*) in a dispute concerning regulatory approaches highlighted the close relationship between revenue requirements and pricing outcomes. PIAC is particularly interested in the Tribunal's comment that much of the weight for the decision to adopt the current pure revenue cap came from the strong support of the NSW industry. Against this, PIAC argued to the Tribunal in the last determination process for the NSW distribution industry (PIAC submission 8/3/99; p.13) that there was a compelling argument for a move towards price cap regulation given the lack of co-operation with the regulatory regime on the part of the businesses. No doubt the problems in the current and previous regulatory periods with the 'unders and overs' accounts owe much to the inherent characteristics of the chosen form of regulation rather than being solely the responsibility of the businesses. On the other hand, these problems contrast with the greater certainty of outcomes arising from price regulation.

Assessing the Options

Efficient prices

If efficient prices were the over-riding objective of this review of the form of economic regulation it is arguable that the Tribunal's task would be far easier. However, other policy objectives such as the fostering of competition and the creation of market proxies, some of which are dictated through the National Electricity Code, mean that the Tribunal has no real capacity to enforce adherence to efficient pricing through the use of price setting or price capping.

In any event, the concept of efficient prices has been transformed by the decision of the Tribunal to permit distribution prices to be determined according to the so-called 'Baumol principles'. This approach, discussed in the Tribunal's decision on *Pricing Principles and Methodologies*, March 2001) describes a zone or range bounded by the incremental and stand alone costs of distribution and within which prices thus are declared to be 'subsidy free'.

As the Tribunal has noted in its discussion paper (p.12), CPI-X regulation appears to have had the effect of encouraging the businesses to maximise their income at the earliest point in each regulatory period, negating all other regulatory incentives. To understand this requires a recognition that CPI-X regulation exists as a response to market power by the businesses as natural monopolies. The outcome of the regulatory arrangements is to make the businesses accountable to the regulator rather than to customers.

NSW distribution businesses are accountable for their total allowable revenue as determined by the Tribunal. The pricing decisions made by the distribution businesses within that regulated allowable revenue are to be made transparent through the operation of the Tribunal's *Pricing Principles and Methodologies*. Nonetheless, the current approach to defining efficient prices means that the businesses enjoy significant room within which they can vary prices and potentially offer a wide range of pricing outcomes to different customers or customer classes. From the perspective of household consumers the issue remains that of whether the principle of 'efficient prices' will have any practical meaning.

Demand Management

The Tribunal's discussion paper (p.13) has put forward the argument that both weighted average price caps and revenue yield price caps fail to provide the DNSPs with any incentive for demand management. It has been the common understanding that revenue caps are more likely to provide the distribution businesses with better incentives to limit the total amount of electricity they sell.

PIAC has previously questioned whether these demand management incentives are sufficient to outweigh the social concerns posed by arrangements where the businesses determine their own prices. The question also needs to be asked as to whether the supposed encouragement for demand management practices on the part of the businesses is real or whether its effect can be observed at all. Since revenue caps implicitly permit trade-offs between price and volume they arguably provide as much incentive to increase electricity sales and 're-balance' prices in favour of the larger volume users. The Tribunal's current inquiry into the provision of demand management by the NSW distribution businesses, and the evidence presented in the *Inquiry Into the Role of Demand Management - Issues Paper*, indicates that to date the application of revenue caps to the NSW industry has made little impact in terms of demand management. This suggests that the Tribunal ought to be looking to regulate for demand management separately to the question of the appropriate form of economic regulation.

PIAC is confident that the Tribunal understands how important the current use of side constraints is to small consumers and especially households on low and fixed incomes. This particular component of the regulatory regime in NSW is now well accepted as a mechanism to constrain the businesses from being too aggressive in 're-balancing' prices with larger customers under the subsidy free approach to prices. If flexibility in prices connotes an ability for prices to rise then household consumers have less interest in flexibility than they do in having predictable, steady prices and reliable supply.

Yours sincerely
Public Interest Advocacy Centre

Jim Wellsmore
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