



SUBMISSION

TO THE

QUEENSLAND COMPETITION AUTHORITY:

DRAFT DECISION ON THE REVIEW OF THE FORM OF

REGULATION OF ELECTRICITY DISTRIBUTION

MAY 2003

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EXECUTIVE SUMMARY

The Queensland Competition Authority (QCA), in accordance with requirements of the National Electricity Code, has recently published its Draft Decision on the form of regulation to apply to electricity distributors for the next regulatory period, commencing mid-2005. That Draft Decision is to maintain the current form of regulation, a fixed revenue cap based on a building blocks approach. The QCA has called for submissions on its Draft Decision by 9 May 2003.

ENERGEX would like to express its surprise and disappointment at the Draft Decision of the QCA not to take the opportunity to evolve the form of regulation from a fixed revenue cap to a weighted average price cap.

If retained, the Draft Decision would consign a highly progressive electricity distribution company, which is actively seeking to meet the needs of its customers, to a regressive regulatory regime for at least a further five years – a regime that has been condemned by the Council of Australian Governments Review of Energy Markets (Parer Review), which recommended a move to price caps as a priority action. Further, a decision by the QCA to reject ENERGEX's recommendation to move to a price cap would, to ENERGEX's knowledge, represent the first time in Australia a regulator has imposed a form of regulation against the wishes of a distributor.

Moreover, there appears to be insufficient evidence in the Draft Decision to support the QCA's conclusion that continuing with a revenue cap is appropriate. Indeed, there is overwhelming evidence that revenue caps have been severely discredited by almost all participants in the regulatory debate, including regulators, and that the debate has settled in favour of price caps some time ago (the arguments in favour of price caps over revenue caps are summarised in the Attachment to this submission). In view of this, the virtually unanimous support for price caps in submissions to the QCA, and the QCA's expressed desire for more light-handed forms of regulation, the QCA's Draft Decision is surprising.

ENERGEX is also disappointed at the QCA's decision to retain the building blocks approach rather than move to a price-service offering model, which it feels would have had great benefits for Queensland. However, ENERGEX does understand the concerns the QCA has raised. ENERGEX believes these concerns can be overcome through ongoing discussions between the QCA, ENERGEX and its customers. Similar discussions are now occurring for ENERGEX's main interstate counterparts, which are already operating under or moving to price caps, and are anticipating more light-handed forms of regulation in the future. Indeed, one jurisdictional regulator has already taken up ENERGEX's ideas and has prepared a version of price-service offerings, and another is moving that way.

The Draft Decision, in making no changes to the current approach to regulation despite the flaws identified, will produce inferior outcomes – for ENERGEX, for our customers, and for Queensland.

While the QCA clearly has some concerns regarding implementation of a price-service offering type model, and is therefore reluctant to endorse its full adoption at this time, it also sees price-service offerings as potentially having a range of positive features. As a consequence, ENERGEX suggests that a transitional approach is warranted. This would entail moving to a weighted average price cap for the next regulatory period under a building blocks approach, and building at least some of the services our customers are demanding into that cap, while working to establish the foundations for a move toward a genuinely light-

handed form of regulation. Such an approach would ensure Queensland does not fall behind other states in progressing toward improved forms of regulation.

ENERGEX believes that the QCA has not fully explored the relevant issues in making this crucial Draft Decision, and that as a consequence, the conclusions drawn are not well balanced. ENERGEX makes the following submission on the QCA's Draft Decision, and in doing so, strongly urges the QCA to fully consider these matters prior to finalising its Decision, which will impact on ENERGEX and its customers until at least 2008 (a further five years).

To this end, ENERGEX has also invited Professor Stephen Littlechild, the originator of price caps and one of the world's most experienced regulators, to visit Australia and put his views. We hope that the QCA will take up our invitation to meet with him at a convenient time.

ENERGEX considers that the Draft Decision does not give appropriate consideration to the balance of evidence presented to the QCA, does not fully take account of contemporary trends to move to more light-handed regulation, and is inconsistent with the QCA's expressed desire to move to a lighter-handed approach. Accordingly, ENERGEX suggests that the Final Decision should reflect the commencement of a move toward more light-handed regulation, by approving a weighted average price cap to apply to ENERGEX's distribution network from 1 July 2005, with additional services to be developed by that date based on the building blocks methodology. This would be a transitional mechanism to a genuinely lighter-handed and more efficient form of regulation in the following regulatory period.

GENERAL COMMENTS

ENERGEX believes that the QCA should give further consideration to a range of relevant issues before finalising its current Draft Decision, in order to ensure the decision is well balanced and reasonable. In particular, ENERGEX urges the QCA to consider changing the recommendation to retain the current fixed revenue cap arrangement. The reasons why a change in decision is warranted include:

1. The Draft Decision is subject to material errors and misinterpretations, including errors of fact, not having regard to all the evidence, the omission of relevant considerations, and the inclusion of irrelevant matters;
2. The Draft Decision may not comply with the wording and intent of the National Electricity Code and relevant Acts; and
3. The Draft Decision represents an opportunity lost, for ENERGEX, its customers, Queensland and ENERGEX's stakeholders, to commence a move to a better and more light-handed form of regulation.

SPECIFIC COMMENTS

1. Draft Decision is subject to material errors and misinterpretations

The Draft Decision (Page 1) may be paraphrased as:

“The QCA supports the view that a more light-handed form of regulation is an appropriate goal but does not intend to start a transition to such a form at this time having regard to the following decision factors:

- *insufficient information;*
- *flexibility under the current framework;*
- *willingness and readiness of distributors;*
- *views of distributors’ customers and key stakeholders;*
- *relevant public interest considerations; and*
- *evolution of regulatory thinking and practice in Australia and internationally.”*

First, the QCA states that a more light-handed form of regulation is “an appropriate goal”. ENERGEX would like to point out that under the National Electricity Code, light-handed regulation is not a goal to be achieved at some point in the future, but a clear objective from the commencement of regulation under the Code (see clause 1.4(b)(i)). ENERGEX suggests that the QCA should be seeking to fulfil such an objective as soon as possible, at the least by moving to a transitional model.

On the specifics of the QCA’s rationale for rejecting a price cap as a transition to such a regime, ENERGEX notes the following.

(i) Insufficient information

The Draft Decision states (p1) that:

- *“the current regulatory arrangements (based on a fixed revenue cap) have been in place for just under two years”,*
- *“the Authority has only received one set of regulatory accounts (for 2001-02) from each distributor, which provides insufficient information for the Authority to satisfactorily judge the performance of both distributors under the current arrangements or gain sufficient insight to determine whether a change to the form of regulation is warranted.”*

Neither of these statements is correct. First, ENERGEX and Ergon have been regulated under a fixed revenue cap for almost six years and not just under two.

Secondly, while there has been only one set of Regulatory Accounts submitted, there is a plethora of information about the performance of ENERGEX available to the QCA, including material provided at the time of the Draft and Final Determination. Indeed, the QCA itself formed very supportive views of ENERGEX’s performance at that time from consultancy and other material. In any event, whatever additional information may be deemed required by the QCA to judge ENERGEX’s performance can also be forthcoming under a weighted average price cap – it is unclear what information advantage is gained by retaining the fixed revenue cap.

Further, the existence or frequency of Regulatory Accounts is not relevant to the judgement of performance or the form of regulation, as:

- decisions to adopt price caps (and other more light-handed regulatory forms) have been made in Australia without the benefit of any Regulatory Accounts, including for instance the price caps that applied to the five privatised distribution companies in Victoria in 1995;
- the QCA itself introduced price caps for gas distribution in Queensland without any Regulatory Accounts; and

- Regulatory Accounts are only a sub-set of statutory accounts, which in ENERGEX's case go back to 1998 and, for its predecessors, beyond.

On Page 1, the Draft Decision notes that the QCA may have arrived at a different conclusion in light of the greater information available at a later date, and refers to Section 6.10.3(d) of the Code, but:

- the implication that the two year notice requirement precludes a decision now to shift to a price cap is incorrect;
- as argued above, greater information is not necessary for the decision to introduce a price cap;
- the intent of Section 6.10.3(d) is to protect regulated companies from having what they may regard as an objectionable form of regulation imposed on them in undue time. This is the opposite case to that which applies here, with ENERGEX seeking a change; and
- even if further information were necessary, further detailed Regulatory Accounts will be available before 1 July 2005.

It therefore appears that there is no reason on these grounds to reject the introduction of a weighted average price cap.

(ii) Flexibility under the current framework

The QCA states that fixed revenue caps afford a high degree of pricing flexibility. This statement tends to provide insufficient weight to the essence of a revenue cap, which requires that any adjustment to prices to accommodate the particular needs of a customer will be made up by price increases or reductions for other customers. It follows that even if there is flexibility to adjust prices under a revenue cap, there is little incentive to do so, and significant risk that trying to introduce flexible pricing for some customers will be to the detriment of others.

Take the further example of a large electricity customer starting up operations in Queensland. The revenue cap does not account for the additional capital expenditure necessary to connect this customer. The additional revenue provided by the customer will be reflected in reduced revenue collected from all other customers rather than in increased revenue to the business, despite the increase in the distributor's costs. To the extent capital expenditure may exceed that forecast by the regulator, the distributor also receives no reward for that investment until a regulatory reset. These examples illustrate the lack of flexibility the business has to adjust to changing market conditions under the revenue cap approach.

As a result, the incentives to adopt flexible pricing arrangements are inherently constrained in operating under a fixed revenue cap, and the pricing flexibility being increasingly demanded by our customers is not enhanced under such a framework.

(iii) Willingness, readiness

The Draft Decision states that ENERGEX and Ergon have different views on the appropriate timing of the transition for their businesses (Page 1).

- This is an irrelevant consideration to the Decision. The views of any one network have no relevance to decisions about the form of regulation to be applied to another under the Code.
- However, if such views were relevant, as the Draft Decision states, then ENERGEX's argument should be supported, as most other distribution businesses in Australia outside

of Queensland operate under various styles of price cap – including those with characteristics most similar to ENERGEX’s network, ie. those in Victoria and NSW.

- In any event, Ergon supports ENERGEX’s position to have a price cap.
- Further, a decision by the QCA to reject ENERGEX’s recommendation to move to a price cap would, to ENERGEX’s knowledge, represent the first time in Australia a regulator has imposed a form of regulation against the wishes of the distributor.

The QCA also states in its Draft Decision that ENERGEX’s support for a price cap appears to be primarily based on the assumption that it would be delinked from costs. Similarly, the QCA assumes that ENERGEX’s criticism of a revenue cap approach is based on it being cost-linked.

ENERGEX does not agree with these statements. ENERGEX’s submission supported the introduction of a weighted average price cap, and the construction of that price cap through a price-service offering approach. Both issues can be considered separately – as indeed the QCA has.

The price-service offering model is in fact linked to costs both at the beginning and end of a regulatory period. The main differences from what applies now are firstly, the overall rewards over the period are higher than the “WACC” for companies that perform well and lower for those that perform poorly, as would apply in a workably competitive market. Second, at the start of the period, there is an allowable return that provides for the risks of innovation and so on, where the company can demonstrate it is working to meet customer needs, as supported by the workably competitive model.

ENERGEX also points out that the models being considered by the ACCC and other regulators, such as TFP, have a much greater de-linking of prices from individual company costs.

ENERGEX’s criticism of a revenue cap does not depend on the ongoing price-cost linkage but does involve many other matters, including inflexibility, management of volume risk, and the failure to replicate any significant feature of a workably competitive market.

Even if the price-service offering model is rejected at this time, this is not relevant to the decision in regard to a price cap.

It follows that given ENERGEX has indicated its willingness and readiness to move to a price cap, the QCA’s reluctance to consider cost-delinked approaches is not grounds to reject a price cap framework.

(iv) Views of customers and other key stakeholders

ENERGEX believes that this is a very relevant consideration. However, the Draft Decision appears not to have taken into account all the evidence on this matter.

- No reference is made to the survey of ENERGEX’s customers conducted by AC Nielsen, even though this represents the only available material on the views of domestic and small businesses. This survey presented strong evidence that a range of additional services are desired by ENERGEX’s customers.
- No reference is made to the views of interested community groups which also support ENERGEX’s position – refer to the letter to the QCA of 5 March 2003. These groups saw benefits in the price-service offering approach for Queensland communities.

- No counter evidence is provided by the QCA on customer or stakeholder views, other than one large customer.

In addition, virtually all submissions that were received by the QCA decried the use of revenue caps. In the QCA's own words, *"no submissions explicitly nominated it [revenue cap] for use in the next regulatory period"* and *"there was most support in submissions for a weighted average price cap"*.

The QCA's conclusions therefore seem very much at odds with the evidence before it.

(v) Public interest

The Draft Decision offers no obvious evidence to support its implied contention that a shift to a price cap is contrary to the public interest. Indeed, the opposite view is more likely.

- The wide application of price caps to electricity distribution businesses under the legislative framework, including by the QCA itself to gas networks, clearly indicates that this approach can be considered to be in the public interest.
- Price caps are a more light-handed form of regulation than revenue caps, offering greater flexibility to meet the needs of individual large customers in particular, and therefore are more in keeping with the intent of the legislative framework, which is a reflection of the public interest.

Again, there is no argument based on this criterion that lends weight to the view that revenue caps should be retained.

(vi) Evolution of regulatory thinking and practice in Australia and internationally

Again, the overwhelming evidence is that revenue caps are now largely redundant in state, national and international regulatory frameworks. While the QCA has considered regulatory practice with respect to cost-delinking, it appears to have not placed significant weight on the almost universal move away from revenue caps by other regulators.

For example, the QCA makes limited reference to the regulation of other distributors in Australia with the only reference made to the Office of the Tasmanian Energy Regulator. For balance, if regard is to be had to experiences in other jurisdictions, the QCA should examine the form of regulation applying in all other jurisdictions, including the rationale for the adoption of weighted average price caps in other jurisdictions in Australia. The Victorian and NSW distribution networks, in particular, are well developed and highly urbanised networks like ENERGEX, and operate under price caps. In Victoria's case, the application of revenue caps has been explicitly ruled out under legislation, while the NSW regulator came to the view that price caps were preferred for the next regulatory period based on essentially the same criteria used by the QCA. In the gas industry, the Gas Code requires that price caps be applied. The balance of evidence when a full review of other jurisdictions is undertaken indicates extensive, well researched and widespread support for price caps, with revenue caps significantly discredited.

The QCA's statement in the Draft Decision, that retention of a revenue cap is consistent with experience in Australian and international jurisdictions, is not able to be reconciled by ENERGEX.

In addition, insufficient regard appears to have been given in the Draft Decision to:

- the Productivity Commission's view that regulators should explore new forms such as total factor productivity, performance benchmarking and price-service offerings;

- the strong support for ENERGEX's approach supplied to the QCA by Professor Littlechild of the UK, the world's most renowned regulator – indeed the QCA has made only passing reference to several implementation issues Professor Littlechild identified, ignoring the many positive statements and findings made;
- the evidence supplied to the QCA by Professor Round, Member of the Australian Competition Tribunal;
- the findings of the recent Parer Review of the National Energy Market, which found that *“immediate changes are needed to address some obvious shortcomings within the current regulatory framework ... The following changes should be made in relation to electricity network regulation: ... Electricity distribution owners should have price, not revenue, caps.”*(p16). This echoes a very widely held view that revenue caps are not an appropriate form of regulation for electricity distribution;
- the findings of the Western Australia Supreme Court on the Epic case; and
- the view of eminent economists and regulators provided by ENERGEX to the QCA in the December submission at Attachment 2.

Again, the Draft Decision does not appear to offer contrary evidence, despite very strong and widespread views that a price cap is a superior form of regulation.

2. Draft decision is potentially incorrect under the legislative framework

All Australian regulatory decisions are governed by the legislative framework which, in this case, includes the National Electricity Code and the *Electricity Act 1994*. Regulators may not make decisions beyond their powers.

The only judicial interpretation of the National Codes which apply to gas and electricity is that of the Western Australia Supreme Court in the Epic case. While this applied to the Gas Code, it is scarcely conceivable that the key decision variables could be interpreted differently from one Code to another as they have the same genesis in policy intent and apply the same concepts and key words.

ENERGEX showed in its December submission (Attachment 4) that the Epic case had two implications for regulatory decision-making:

- the neoclassical approach to decision-making (eg building block approach and the weighted average cost of capital model) is incorrect under the law; and
- what is correct under the law is the replication of a workably competitive market.

The Draft Decision appears to have had little regard to these matters and to the supporting views of Professors Littlechild (Attachment 7) and Round (Attachment 8), and to the submissions to the QCA by AusCID and the AGA.

In addition, the whole regulatory framework is evolving rapidly in Australia as the implications of the Epic case are being considered, with:

- the draft terms of reference to the Gas Code Review referring to Epic;
- regulators, including the ACCC and the Victorian ESC, considering Epic and noting that it has “fundamental implications”;
- industry associations gearing up to support Epic type new forms of regulation; and
- all pipelines in Australia in dispute with regulators on regulatory determinations, as matters which refer to the Epic case.

This Draft Decision seems to have had insufficient regard to these relevant matters.

3. Opportunities lost

ENERGEX is a vigorously competitive and entrepreneurial company that is constrained, both in terms of developing new distribution services and in the flexible pricing of those services, by the current regulatory arrangements.

The QCA has suggested that the incentive to “innovate” to reduce costs is greater through a revenue cap than a price cap. ENERGEX would first point out that the word “innovation” in economic regulation does not refer only to costs (productive efficiency) but also the much more important element of economic efficiency – dynamic efficiency. As argued in ENERGEX’s December submission; there is no dynamic efficiency under the current framework. Secondly, in any event, the focus on cost-cutting as being equivalent to improving efficiency is overly narrow and can become quite detrimental to any company and to the public interest if taken too far.

ENERGEX’s December submission listed a wide variety of the services that are sought by our customers and could be provided under a new form of regulation. As the decision by the Western Australia Supreme Court makes clear, this is precisely what the legislative framework seeks to promote.

ENERGEX submits that the continuation of the present arrangements is not in the interests of ENERGEX, its customers or Queensland and is contrary to the intentions of the legislative framework and to the public interest.

4. Alternative option

The Draft Decision argues that two concerns are that:

- it is possible not all monopoly rents have been stripped from ENERGEX’s prices; and
- customers have insufficient knowledge of what represents value for money in relation to distribution services to allow them to determine the appropriate balance of prices and service quality.

ENERGEX accepts that these concerns are very real for the QCA and therefore suggests an alternative to what may be regarded as the more comprehensive version of a workably competitive market over a transition period.

That alternative would have the following characteristics.

- A decision now to install a weighted average price cap to operate from 1 July 2005, based on a building block approach.
- Continuation of the provision of Regulatory Accounts and other information to the QCA to enable monitoring of ENERGEX’s performance.
- The construction of additional services (selected by the QCA and ENERGEX) based on costs of provision and building blocks.
- Individual incentives and penalties for each of the additional services.

ENERGEX to work cooperatively with the QCA and customers to develop a price-service offering framework acceptable to all parties.

This approach has the benefit of satisfying all of the QCA's criteria for an appropriate decision on the form of regulation to apply in the next regulatory period, while creating a transition phase during which ENERGEX would be required to demonstrate its commitment to meeting customer needs.

5. Conclusion

ENERGEX appreciates the QCA releasing its decision in draft form on this crucial matter, to enable further public comment to be sought.

ENERGEX can understand the QCA's reluctance at this time to move towards a full price-service regulatory model. However, given the significant weight of evidence on the benefits of price caps, moves by other regulators to introduce price caps in recognition of these benefits, and widespread support from virtually all stakeholders, it is difficult to understand how the QCA has concluded that a revenue cap is a more appropriate form of regulation than a price cap. In ENERGEX's view, a detailed and balanced analysis of the issues and written submissions should result in a decision to move the form of regulation from a revenue cap to a price cap, as the commencement of a transition toward a more light-handed form of regulation.

ENERGEX strongly urges the QCA to reconsider its Draft Decision to apply a revenue cap to ENERGEX for the next regulatory period, in favour of the transitional model identified above.

ATTACHMENT

SUMMARY OF BENEFITS OF PRICE CAPS OVER REVENUE CAPS

- **Demand growth risk:** as prices rather than revenues are capped, the distributor wears the risk of demand growth being above or below that which was forecast. This is recognised as an appropriate risk for distributors to carry, given they are much better placed to manage this risk than consumers, who ultimately bear demand or volume risk under a revenue cap.
- **Flexibility in developing the business:** under a revenue cap, capital expenditure above that approved by the regulatory will not earn a return, even where the expenditure is perfectly legitimate, at least until the end of the current regulatory period. However, under a price cap, while the regulator sets a benchmark level of capital expenditure for each year of the regulatory period, there is nothing to prevent the business spending further capex where it is viable to do so, ie. where the additional revenue, generated at the approved tariff, covers the costs of the additional infrastructure. This adds greatly to flexibility in terms of the capex program, and more generally in terms of the ability of the business to change to meet market developments.
- **Flexibility in price structure:** under a weighted average price cap, the price constraint is applied as an average across the business, or across geographic zones or customer classes. Within this constraint, there is increased scope to adjust actual prices, without providing windfall penalties or rewards to other customers on the network in order to meet a particular revenue requirement. Accordingly, the revenue cap approach significantly dilutes the incentive to adopt flexible pricing structures.
- **Greater certainty in respect of prices to consumers:** Under a price cap approach, the price path can be set for the duration of the regulatory period, giving customers certainty in relation to pricing requirements. In contrast, under a revenue cap, prices can fluctuate in line with, for example, adjustments to reflect unders and overs, leading to greater uncertainty in relation to prices on a year to year basis.