



Final Decision

**Form of Regulation of Electricity
Distribution to commence from
1 July 2005**

June 2003

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1. OVERVIEW

This document outlines the Authority's final decision on the form of regulation to apply to the Queensland electricity distributors, Ergon Energy and Energex, for the regulatory period commencing 1 July 2005.

1.1 The Current Review

The Authority's Final Determination on the Regulation of Electricity Distribution (QCA 2001) set the regulatory framework for the period 1 July 2001 to 30 June 2005. In its Final Determination, the Authority opted to regulate the Queensland electricity distribution networks by setting a fixed revenue cap for each of the four years of the proposed initial regulatory period, along with some secondary price controls to limit price shocks to customers.

Section 6.10.3(d) of the Code requires that, if the Authority proposes to change from the current form of regulation, it must give two years prior notice to distributors of the new form of regulation to apply from the commencement of the next regulatory period and publish a description of the process and timetable for re-setting the form of regulation that allows all affected parties to participate.

The Authority released a Discussion Paper *Review of the Form of Regulation of Electricity Distribution* ('the Discussion Paper') in October 2002 to assist stakeholders in making submissions to the current review and to provide a description of the process and timetable for re-setting the form of regulation. The Authority received ten submissions, which are available on its website at www.qca.org.au.

On 14 April 2003, the Authority released its draft decision on the *Form of Regulation of Electricity Distribution to commence from 1 July 2005* ('the Draft Decision'). Following consideration of the issues raised in initial submissions, the Authority indicated that it was minded to maintain the current form of regulation for the next regulatory period. In large part, this reflected the Authority's reluctance to move away from the current fixed revenue cap arrangements so soon after implementing them and with only one year of data and experience to assess how the current regulatory regime was functioning and upon which to base its decision.

Three submissions were received in response to the Draft Decision, from Ergon Energy, Energex and the Queensland Government's Office of Energy. Following consideration of the views raised in these submissions, the Authority has maintained its draft decision not to change the form of regulation for the next regulatory period. The Authority considers that the lack of certainty about the appropriateness of existing distribution prices and the continued removal of monopoly rents while ensuring the financial viability of the distributors are important reasons for maintaining the fixed revenue cap arrangements for the next regulatory period.

This final decision outlines the Authority's response to the key matters raised in the submissions on the Draft Decision. The Authority has not revisited matters previously addressed in the Draft Decision. The current review is focused on the form of regulation only and is not concerned with deciding the details of how the chosen form of regulation will be implemented.

Having determined the form of regulation, the Authority will move on to consider the detail and implementation of this form of regulation prior to the end of the current regulatory period in mid-2005.

2. RESPONSES TO THE AUTHORITY’S DRAFT DECISION

In response to its Draft Decision to maintain the current fixed revenue cap form of regulation to apply to Queensland electricity distributors for the regulatory period commencing 1 July 2005, the Authority received submissions from Ergon Energy, the Queensland Government’s Office of Energy and Energex.

2.1 Ergon Energy

The key issue raised by Ergon Energy related to the risk it faced due to unanticipated operating costs or capital expenditure under a fixed revenue cap. In particular, Ergon identified unanticipated increases in load arising from the installation of air conditioners and the requirements of unanticipated large customers as being the most likely determinants of deviations from forecast operating costs and capital expenditure.

The Authority appreciates Ergon Energy’s concerns in relation to forecasting. To address these issues in the current regulatory arrangements, the Authority included provisions to enable within-period adjustments of allowed revenue in certain circumstances. The current provisions could be more tightly formulated to provide greater certainty to the distributors, but at a cost of less certainty for customers. While the Authority understands Ergon Energy’s desire to more explicitly specify such provisions under the next set of regulatory arrangements, the Authority does not believe that a hybrid revenue cap is the appropriate mechanism to address such concerns at this time and remains of the view that such issues will be best addressed in the process of developing the next regulatory arrangements. Further, the Authority does not consider that now is the appropriate time to be making decisions regarding the detail of those arrangements.

2.2 Queensland Government’s Office of Energy

The Office of Energy supported the implementation of a form of regulation that most closely replicates efficient market signals, is transparent and has a low compliance burden. However, it regarded a clear priority of regulation of natural monopoly infrastructure to be to reduce costs while maintaining service quality. It argued that revenue cap regulation provided distributors with the incentive to reduce costs because this is the only way for the regulated entity to improve profits.

The Office of Energy also argued that it was premature to discount the ongoing effectiveness of a revenue cap approach at this stage when there were limited results from the present regulatory arrangements. It supported the continued use of the ‘building block’ approach to setting the revenue cap and the development of a service quality regime in the next regulatory period.

2.3 Energex

Energex raised a number of issues in relation to the Draft Decision which can be summarised as follows:

- the Draft Decision is subject to material errors and misinterpretations having regard to:
 - the availability of sufficient relevant information;
 - the degree of flexibility under the current framework;
 - the willingness and readiness of distributors to move to more light-handed forms of regulation;

- the views of distributors’ customers and key stakeholders;
- relevant public interest considerations; and
- the evolution of regulatory thinking and practice in Australia and internationally;
- the Draft Decision is potentially incorrect under the legislative framework; and
- opportunities could be lost due to the Authority’s proposed decision on the form of regulation.

Energex also proposed an alternative regulatory option involving a weighted average price cap form of regulation with the price caps based on a building block assessment of costs.

Draft Decision is Subject to Material Errors and Misinterpretations

Energex suggested that the Authority had erred in stating its view that a more light-handed form of regulation was “an appropriate goal” as clause 1.4(b)(1) of the Code stated that one of the “objectives” of the Code is to “provide a regime of “light-handed” regulation of the market to achieve the market objectives”.

This is a semantic point. The drafting of the Code gives clear direction as to forms of regulation that meet the objective set out in clause 1.4(b)(1). Clause 6.10.5(b) states that the jurisdictional regulator is to choose between three forms of regulation, a revenue cap, a weighted average price cap, or a combination of the two.

Not only does the Authority believe its choice of one of the forms of regulation specified in the Code is consistent with the objectives of the Code, but it is also satisfied that this choice is also consistent with the objectives of the Code relating to the distribution service pricing regulatory regime to be administered by jurisdictional regulators outlined in clause 6.10.2.

Insufficient Information

The Authority’s choice of the form of regulation has been based on the relevant information currently before it and the regulatory objectives it is seeking to achieve in the next regulatory period. Energex suggested that there was ample evidence available to support its move to a new form of regulation.

The Authority acknowledges that revenue caps for the Queensland distribution corporations were established by the Minister for Mines and Energy in 1997. However, there is little publicly available information on the financial and service performance of the distributors under those revenue caps.

As the Authority indicated in its Draft Decision, it has only one set of regulatory accounts (for 2001-02) from the distributors under the current regulatory arrangements and the distributors only commenced publicly reporting service quality data in February 2003, with data for the September quarter 2002. As a result, the first year for which information will be available for both the financial and service performance of the distributors will be 2002-03, due to be provided to the Authority by the end of October 2003. As financial and service performance are closely linked, with the potential for each to be traded off against the other, the Authority currently has insufficient information to assess the distributors’ performance under the current arrangements.

Energex suggested in its submission that the availability of historical statutory accounting information should provide the Authority with the sort of information it requires because regulatory accounts are a subset of statutory accounts. However, it is very difficult to separate the historical financial data relating to Energex’s regulated distribution business from the aggregated statutory accounts that include data on its retail, gas and other subsidiaries. As a result, the historical statutory accounts provide only limited relevant financial information for the Authority’s purposes.

In addition, a particular concern at the time of the Final Determination was the trade-off between operating efficiency and service quality. In recognition of the potential for single-minded pursuit of efficiency gains to threaten service quality standards, the Authority adopted a more relaxed approach to operating efficiency targets in the Final Determination. It is impossible for the Authority to determine, at this stage, whether the (more modest) efficiency gains have been achieved or whether there has been any impact on service quality standards.

Energex also stated that it was unclear what information advantage was to be gained by retaining a fixed revenue cap. However, this is not the relevant issue. The question before the Authority was whether there should be any change to the current form of regulation. In the absence of a broad spectrum of information on Energex’s performance, in relation to both financial and service quality performance under that regime, it is difficult to justify a move away from a fixed revenue cap at the present time.

As stated in its Draft Decision, the Authority is concerned about moving to a weighted average price cap when there is insufficient evidence to conclude that the current arrangements have ensured that distributors’ current prices are reasonable, service quality outcomes remain uncertain and customers have insufficient knowledge of what represents value for money in relation to distribution services. The Authority regards these as key objectives to be achieved in the next regulatory period.

Flexibility Under the Current Framework

The Authority addressed the flexibility it considers to be available under fixed revenue cap arrangements in its Draft Decision.

The cost building blocks that are used to construct fixed revenue caps take account of growth in the use of network services by existing and future customers. While the Authority accepts that the forecasts used in this process will be subject to error (up or down), responsibility for forecasts rests as much with the distributors as any other party. To the extent that forecasts and actual outcomes differ, this will largely reflect the ability of the distributors to forecast developments in their own business environment. Variations against such forecasts represent a risk to the business regardless of the form of regulation. Nevertheless, as previously discussed with respect to Ergon Energy’s submission, under the current arrangements there is scope for within-period adjustments of allowed revenue in certain circumstances. Similar provisions could be built into the arrangements for the next regulatory period which provide a safety net for distributors in circumstances where forecasts vary significantly from actual outcomes.

The Authority acknowledges that there is limited incentive to grow revenue under a fixed revenue cap compared to the incentive that might exist under a weighted average price cap. Such a factor has been given a low weighting at this point in the evolution of electricity distribution regulation in Queensland compared to the promotion of cost efficiency and related pricing. At the same time, the revenue cap arrangements protect distributors from risks associated with demand falling below expectations.

Under any of the forms of regulation available to the Authority, distributors should have an incentive to pursue efficient prices because better signalling to customers of the costs of the services they receive should promote more efficient use of existing infrastructure.

Willingness and Readiness of Distributors to Move to More Light-handed Forms of Regulation

Energex suggested that the Authority incorrectly interpreted Energex’s support for a price cap as being solely related to the issue of whether the form of regulation was cost based. However, the Authority’s draft decision to maintain the current form of regulation was not related to whether the implementation of that form of regulation was cost based or not. The Authority is not convinced by the evidence it has before it now, that it is appropriate to move to a weighted average price cap in the next regulatory period.

Energex also questioned whether the Authority’s draft decision in relation to Energex had been inappropriately influenced by views expressed by Ergon Energy. In the Draft Decision, the Authority made it quite clear that it had assessed the respective arguments of Ergon Energy and Energex in favour of different forms of regulation independently, recognising that their interests were not necessarily complementary. While a regulated firm’s view about the form of regulation that will be applied to it is an important consideration, that is not the only matter to be taken into account. The Authority must also give due weight to a broader range of interests affecting all stakeholders, including those of customers and matters of public interest.

Energex suggested that the Authority was out of step with other Australian regulators by deciding to continue with a revenue cap form of regulation in the next regulatory period. However, of the seven jurisdictions, five currently apply, or have indicated that they will apply, either a fixed or average revenue cap form of regulation to electricity distribution. The ACCC also applies a revenue cap form of regulation to electricity transmission.

Views of Customers and Other Key Stakeholders

Energex claimed that the Authority had not taken sufficient account of customers’ views on particular aspects of the distribution services they receive. While the Authority has had regard to the views of customers about the services they receive, for example, the Authority has consulted the distributors’ customers as part of its development of a service quality incentive regime for the next regulatory period, this is not particularly relevant to the decision about the form of regulation.

As discussed in the Draft Decision, the Authority does not consider that the form of regulation necessarily or unduly restricts the services that can be offered to customers.

The Authority has already made clear its intention to incorporate some form of service quality incentive regime into the next regulatory arrangements. The service quality regime should provide incentives for distributors to align the quality of services they provide with customer expectations.

Customers’ preferences in relation to distribution services, how distributors intend to meet those preferences and at what cost, are matters to be considered as part of the implementation of whichever form of regulation the Authority chooses to adopt.

Public Interest

Energex suggested that the Authority’s Draft Decision implied that a shift to a price cap form of regulation was contrary to the public interest. The Authority made no such suggestion. At the same time, the Authority does not agree that price caps are more in keeping with the intent of the legislative framework, which is a reflection of the public interest, since both revenue and

price caps are explicitly offered as alternative forms of regulation that can be adopted under the Code. Both price and revenue caps can be consistent with the public interest, which is concerned with the balancing of a range of matters, including social welfare and equity considerations, the interests of consumers, the need to promote competition, and the efficient allocation of resources.

Evolution of Regulatory Thinking and Practice in Australia and Internationally

As already noted, the Authority does not share the view expressed by Energex that revenue caps are largely redundant in state, national and international regulatory frameworks.

The Authority’s Discussion Paper canvassed the advantages and disadvantages of the forms of regulation available to it under the Code. The Authority is aware that each form of regulation has a different balance of advantages and disadvantages.

The various forms of regulation can be viewed as a continuum – from the most direct, such as rate of return regulation, through to more flexible forms based on broad measures of performance and benchmarking. The Authority accepts that it would be desirable to progress along that continuum, but does not believe that there is currently sufficient information available to support a decision to move away from a revenue cap form of regulation at this time.

Draft Decision is Potentially Incorrect Under the Legislative Framework

The Authority does not consider that choosing one of the three forms of regulation specified in the Code is at odds with the legislative framework.

Opportunities Lost

As previously discussed, the Authority is not convinced that Energex is unable to deliver new services to its customers under a revenue cap form of regulation. To the extent that Energex is able to identify new services desired by customers and the costs of providing those services, they can be accommodated within a revenue cap form of regulation.

Alternative Option

Energex proposed an alternative option for the form of regulation. This option involved:

- the Authority deciding on a weighted average price cap as the form of regulation for the next regulatory period, with the price caps to be based on a cost building block approach;
- Energex continuing to provide Regulatory Accounts and other information to the Authority to allow it to monitor Energex’s performance;
- construction of additional services (to be selected by the Authority and Energex) based on cost of provision and building blocks; and
- individual incentives and penalties for each of the additional services.

This alternative approach has already been considered. In arriving at its Draft Decision, the Authority explicitly considered the relative merits of a revenue cap and a weighted average price cap based on a building block approach and was minded not to move to a weighted average price cap. While not relevant to the decision on the form of regulation, Energex will be required to continue to provide Regulatory Accounts and other information to the Authority regardless of the form of regulation.

As already noted, if Energex wishes to identify and cost new services, these can be accommodated within either form of regulation.

Finally, the Authority is already proceeding to develop a service quality incentive regime for introduction in the next regulatory period. This regime will introduce appropriate incentives and penalties to encourage distributors to respond to customer expectations on all services offered.

3. THE AUTHORITY'S DECISION

Having considered all relevant issues, including those raised by stakeholders, the Authority has decided not to change the form of regulation for the next regulatory period. As a result, fixed revenue caps will be applied to the distribution networks of Ergon Energy and Energex from 1 July 2005, for a period to be decided as part of the resolution of the detail of the next regulatory arrangements for each distributor.

4. PROCESSES AND TIMETABLE FOR 2005 DETERMINATION

Having decided the form of regulation to apply in the next regulatory period, the Authority will commence work on key inputs associated with the implementation and detail of the regulatory arrangements for each distributor. Key steps to be completed will include:

- valuing each distributor's regulatory asset base;
- assessing capital expenditure requirements, including reviewing the efficiency of capital expenditure incurred in the 2001-2005 regulatory period;
- assessing operating expenditure requirements, including reviewing the efficiency of operating costs incurred in the 2001-2005 regulatory period;
- assessing cost of capital and rate of return issues; and
- determining other aspects of the next regulatory arrangements, including the service quality incentive regime, secondary price controls and an efficiency carryover mechanism.

The Authority anticipates releasing a draft determination on the regulatory arrangements to apply from 1 July 2005 by late 2004. A final determination should be released in early 2005 in order to allow sufficient time for the approval of the distributors' prices for 2005-06. Throughout this process, the Authority will provide regular opportunities for stakeholders to have an input to decisions and to inform the Authority of their views on the full range of issues.

5. REFERENCES

Department of Mines and Energy, 2000. Ergon – Energex Regulatory Determination.

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Queensland Competition Authority, 2001. Final Determination: Regulation of Electricity Distribution, May.