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Mr Gary Henry,
Queensland Competition Authority
GPO Box 2257
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Dear Mr Henry:

Thanks for the opportunity to comment on your Review of the Form of Regulation of Electricity Distribution, which I found to be a very well informed document within a well-developed process. I thought the approach of the paper was so impressive that I used it as a case study in my graduate class in Regulatory Economics at the University of Calgary. I therefore begin by commending the Authority on its sophisticated approach to dealing with the issues addressed by the paper.

I am Assistant Professor of Economics at the University of Calgary, specializing in regulation and competition policy. I have consulted extensively on matters relating to regulation (regarding electricity, natural gas distribution, and telecom) and my comments reflect both my research and consulting experience.

The review paper seeks comments on several different issues regarding the choice between regulating with a revenue cap vs. a price cap for electricity distribution companies (discos) in Queensland. I have listed my comments below according to the numbering of the discussion paper.

5.1 The Allocation of Volume Risk

My impression is that the single most important issue in this decision is to obtain an appropriate allocation of risk between consumers and discos. Since discos' costs are mostly fixed, it is clear that the revenue cap provides the least risk for them; under a price cap, their revenues will vary according to fluctuations in demand which are unlikely to have a significant effect on their costs. However, the revenue cap appears at first to create more risk for consumers, since prices will increase in years when demand is lower than expected.

I claim that this appearance of additional risk for consumers is illusory, however, for two reasons. First, distribution charges make up only a fraction of the total electricity price. Second, one should think about why demand might fluctuate. Most unexpected variations in electricity demand are driven by the weather: if the temperature is below normal, demand falls, and consumers' total electricity bill falls. But low demand periods are exactly when the disco regulated under a revenue cap will increase its prices. Therefore when the consumer has low electricity charges, the distribution charges will slightly increase. Similarly, when demand is high, because of hot weather, the distribution charge will have to decrease. This means that the revenue cap provides a kind of natural hedge for consumers, since it creates a price for distribution which varies inversely with the volume of electricity demanded as well as the price of electricity.

In summary, the revenue cap reduces risks for both consumers and discos, and is therefore strongly preferred in terms of the allocation of risk.

5.2 Incentives to set efficient prices

My only comment on this section is that the critique by Crew and Kleindorfer (1996) of revenue caps as potentially creating incentives to produce a lower level of output than an unregulated monopolist does not appear to have any *practical* relevance to the situation of electricity distributors in Queensland or anywhere else. The demand for electricity is so inelastic that an increase in the distribution charge will in general lead to minuscule decreases in volume and accordingly no meaningful cost savings for the disco. For the disco to reach pricing above the unregulated monopolist, but still remain inside the revenue cap would likely require distribution charges hundreds of times higher than the current levels.

5.6 Demand side management

Demand side management is likely to become increasingly important during the next ten years, especially if global warming and/or the Kyoto Accord gain more impetus. It is also possible that improved metering technologies will enable real time metering for an increasing number of customers, which is likely to lead to lower peak period demand and possibly higher off-peak demand. Therefore, I believe it is desirable to allow for a form of regulation which allows for more flexibility to encourage demand side management programmes. It is clear that revenue caps are much more helpful in this respect than price caps.

5.7 Transparency

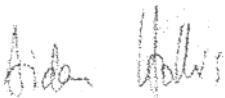
Since a revenue cap is currently in use in Queensland, the QCA will have accumulated several years of experience in using the revenue cap for discos by 2005. Changing the form of regulation to a price cap will require both the QCA and the discos to change to a new regime, which is expensive for all parties. Experience with a given regulatory scheme is valuable for all parties, but especially for the regulator.

Other issues

One issue which should be considered is the extent to which the chosen regulatory form allows for benchmarking with other discos in Australia. Benchmarking is a very useful tool, even if not formally a part of the regulatory agreement.

I hope that these comments will be useful in your decision-making. I plan to be in Brisbane from around September 2003 until April 2004, and would welcome the opportunity to discuss these and other issues with you at that time in person, or by email at the address ahollis@ucalgary.ca at any time.

Yours truly,



Aidan Hollis,
Assistant Professor