



11 FEB 2003



Treasury

Mr G Henry
Queensland Competition Authority
GPO Box 2257
BRISBANE QLD 4001

Dear Mr Henry

Review of the Form of Regulation of Electricity Distribution

Thank you for providing Queensland Treasury with the opportunity to respond to the Queensland Competition Authority's (QCA) *Review of the Form of Regulation of Electricity Distribution*. Please find attached Queensland Treasury's submission to the review, which has been prepared in consultation with the Office of Energy.

In addition, Queensland Treasury has noted the assessment undertaken by the QCA did not directly consider the potential use of productivity-based benchmarking in the pricing for electricity distribution. I note the recent Productivity Commission recommendation that further exploration of benchmarking in access regulation in Australia should be conducted. While the National Electricity Code (the Code) constrains the QCA to examining regulation of electricity distribution entities within the CPI-X framework (or some equivalent), the use of benchmarking is not ruled out by the Code.

Accordingly, I would support any future examination of changes to the form of regulation for distribution entities including an assessment of the potential value of benchmarking.

If you have any further queries regarding the Queensland Treasury submission, please contact Mr Richard O'Shea on (07) 3239 3887.

Yours sincerely

(G. Bradley)
Under Treasurer

Encl.

Attachment

The following is Queensland Treasury's submission to the *Review of the Form of Regulation for Electricity Distribution*.

The Authority seeks the views of the stakeholders on what criteria the form of regulation should be assessed against and the relative importance of each of these.

Queensland Treasury recognises this review is 'high level' in nature, and that the effectiveness of the form of regulation will be largely determined by the specific factors associated with implementation. For this reason, the Queensland Competition Authority (QCA) should be mindful that the selected form of regulation does not rule out innovative regulatory tools and approaches that may be considered at a later time.

The discussion paper lists the following objectives as traditionally given "high priority" by regulators:

- Minimise the overall cost of volume risk;
- Provide distributors with incentives to set efficient prices;
- Provide flexibility in pricing design;
- Not be highly sensitive to inaccurate volume forecasts;
- Provide incentives to reduce costs;
- Not constitute a barrier to demand management;
- Minimise problems associated with reconciling forecast and actual volumes of electricity distributed;
- Be transparent; and
- Require minimal mid-period adjustments of the revenue or price caps.

These criteria generally encompass most of the aims of effective regulation, however in addition to these objectives Queensland Treasury would like the form of regulation to:

- Minimise regulatory complexity;
- Facilitate efficient investment in electricity distribution;
- Provide strong incentives and flexibility for service providers to pursue innovation and productivity gains; and
- Allow for the appropriate sharing of risks between customers (through prices) and service providers (profits).

Further, the Competition Principles Agreement proscribes general criteria which could be used to assess the form of regulation. An examination of the potential use of these criteria would add value to the Review.

Queensland Treasury has not commented on the relative merits of the identified criteria, as it is considered that comment is best left to industry participants.

The Authority seeks comments from stakeholders on the broad form of regulation most suited to regulating Queensland distributors in the next regulatory period.

It is the view of Queensland Treasury that given the constraints imposed by the Code, the weighted average price cap would be the most appropriate form of regulation.

The Authority would welcome comment on alternative regulatory models that meet the requirements of the Code and that stakeholders believe warrant consideration.

Queensland Treasury notes that regulation of electricity distribution must be CPI-X or a variant thereof. Given the scope of this process, Queensland Treasury does not propose any alternative forms of regulation to those proposed by the QCA. The proposed broad options appear to contain sufficient flexibility to meet the objectives of the Code.

Notwithstanding this, Queensland Treasury would like the Review to examine productivity benchmarking, within the price cap approach to regulation.

The Authority seeks the views of stakeholders on the most appropriate form of regulation generally.

This submission has previously stated that Queensland Treasury views, given the constraints imposed by the Code, the weighted average price cap as the most appropriate form of regulation. This is for the following reasons (expanded upon below):

- The price cap framework should ensure strong incentives for the pursuit of productivity improvements are encouraged;
- The weighted average price cap allows flexibility since multiple components of service delivery will be recognised, allowing individual prices to be traded-off against each other;
- A price cap approach allows scope to send signals to the market to encourage desired consumption patterns. Basic price caps may be supplemented by rewards and punishments, or other measures to achieve demand management objectives; and
- Price caps can provide greater certainty with regard to price over time in the face of inevitable disparities between forecast and actual demand.

and, in particular, on which form of regulation:

- **is likely to deliver the most appropriate allocation of risk between distributors and customers;**

From a customer perspective, allocation of risk should mean that prices share a positive relationship with service productivity, and encourages new investment to ensure future demand is met. Price cap regulation has a stronger framework than revenue cap in this regard, as revenue shortfalls from lower-than-expected demand cannot automatically be mitigated by price increases.

Importantly, the implementation of a price cap framework should ensure that strong incentives for the distributor to pursue productivity are maintained.

- **provides the most appropriate incentive for efficient pricing and scope for pricing flexibility;**

At face value, a revenue cap allows greater flexibility than a direct price constraint. However, the use of a weighted average price cap implies that multiple components of service delivery will be recognised, allowing the flexibility to trade-off individual prices against each other within the weighted average cap. This form of pricing freedom does not allow the business to raise prices in the face of low volumes, only to encourage consumption patterns that (should) correspond with improved productivity and economic benefit. This form of pricing flexibility has direct application to effective demand management.

The challenge for the regulator is to allow the business a level of freedom to adjust pricing in order to encourage customer behaviour that will enhance overall business productivity. This is discussed further below with regard to demand management.

- **is least sensitive to inaccurate volume forecasts;**

Price sensitivity to inaccurate demand forecasts is greatest under a revenue cap approach. However, the insensitivity of a price cap may not be desirable if realised demand varies considerably from forecasts. In short, the objectives of the regulator with regard to benefit-sharing will not be achieved under a simple price cap unless demand forecasts are accurate.

The solution could be to attach a predetermined benefit-sharing mechanism that will automatically adjust the price cap in the event of demand fluctuations. This option has been proposed by the ACCC in relation to Greenfields gas pipelines.

- **provides useful incentives to reduce costs;**

Each option corresponds with the CPI-X framework, which carries a basic incentive for the firm to reduce costs.

Queensland Treasury considers that most serious perverse incentives with regard to cost reduction arise from the method of calculating economic variables such as the regulated asset base and operating costs. There should be an examination of the benefit of introducing productivity-based benchmarking as an alternative to the building block approach. This view lends itself to support for the selection of a price cap approach to regulation, as the outcome-focussed benchmarking approach is more suited to using price as the key variable.

- **is most appropriately weighted to recognising the role for demand side management; and**

Queensland Treasury agrees with the basic QCA analysis that a fixed revenue cap approach is best suited to recognising demand side management because the service provider has no incentive to increase demand volumes. However, a price cap approach, as discussed above, allows scope to send signals to the market to encourage desired consumption patterns. Basic price caps may be supplemented by rewards and punishments, or other measures such as 'green credits', to achieve demand management objectives. A fixed revenue cap approach carries risks that such signals will be diluted or removed by price adjustments that are made in response to demand fluctuations.

- **provides the most acceptable degree of transparency.**

Queensland Treasury notes the QCA summary on this issue, but is not entirely convinced by the argument. While revenue caps may give the appearance of transparency in regulatory decisions, the impacts on consumers (i.e. prices of the services) are not necessarily clear. The Productivity Commission's Review of the National Access Regime states that the absolute revenue caps used in Australia, and particularly for the gas and electricity industries, means that the business or facility has the freedom to set prices subject to the constraint that it cannot earn more than a specified dollar amount of revenue in any one year. This potentially creates the freedom to vary prices so long as the revenue constraint is not breached. Price caps, even in conjunction with a potentially complex benefit sharing mechanism, can provide greater certainty with regard to price over time in the face of inevitable disparities between forecast and actual demand.

The Authority would welcome comments on any other criteria that stakeholders believe warrant consideration in comparing the different forms of regulation allowed under the Code.

Queensland Treasury has no comment on any additional criteria for the comparison of different forms of regulation, as comment is best left to industry participants.

The Authority seeks the comments on the approach that should be used to minimise the difference between forecast and actual volumes, and where this includes a correction mechanism, what form this might take.

Queensland Treasury has no comment on the best approach to minimise the difference between forecast and actual volumes, as comment is best left to industry participants.

However, Queensland Treasury notes that there might be a need to treat differently, new and existing infrastructure. An example of this is the ACCC proposal for Greenfields gas pipelines, where solution to price sensitivity to inaccurate demand forecasts is to attach a predetermined benefit-sharing mechanism that will automatically adjust the price cap in the event of demand fluctuations.

The Authority seeks comments on the possibility of using more than one form of regulation in the next regulatory period.

At a broad level, consistency across both distribution networks would be desirable in order to minimise regulatory complexity. The high-level nature of this process tends to suggest that the QCA should be able to make a definitive judgment as to which form of regulation is likely to provide the best outcomes for an electricity distribution business, and then apply this to both networks. Differences between the two incumbent businesses are best addressed during the more precise implementation phase that will be conducted over the next two years.

Additional Comments

Queensland Treasury would encourage regulators to explore less intrusive forms of price setting, and notes the recent Productivity Commission recommendation that further exploration of benchmarking in access regulation in Australia should be conducted.

A revenue cap approach is not suited to such benchmarking, as productivity based price movements (contained within the X factor) may be made redundant by volume risks and their subsequent effect on prices. A price cap approach allows a much more direct flow through of productivity improvements to regulated prices.

In this light, Queensland Treasury is concerned that the selection of a revenue cap approach at this stage will 'close the door' on the consideration of productivity based benchmarking.