

18 October 2002

Mr John Martin
Forum Chairman
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Dear Mr Martin

Report on linked versus unlinked styles of regulation

EnergyAustralia is pleased to comment on the report from Farrier Swier undertaken for the Utility Regulators Forum which investigates potential changes to the regulatory framework for monopoly network businesses in Australia.

The report gives a general overview of alternative techniques for regulation of network businesses. While the report makes no clear recommendation on the way forward, it does provide interesting observations about practical and implementation issues associated with any move to an alternative "unlinked" regime.

While supportive of further development of regulation within the NEM, EnergyAustralia is of the view that continued refinement of the current arrangements is likely to unlock additional benefits and efficiencies within the current framework without introducing further uncertainty and the potential for substantial transaction costs in moving from the current framework.

Potential for arbitrary decisions

Farrier Swier states in its report that the framework itself is not the determinant of effective regulation per se but rather "the restraint of arbitrary administrative action".¹ EnergyAustralia agrees with this statement and believes that despite the building block approach becoming better understood within the Australian context, there remains the potential for arbitrary decisions to be made by regulators that can disrupt the smooth operation of this, or any, regime.

EnergyAustralia believes that the potential for arbitrary decisions is already having an adverse effect on investment in the Australian market and that this effect has the potential to become more serious if regulators are not held to account. EnergyAustralia believes this will remain the case regardless of whether a new regime is introduced, and has the potential to become worse if significant changes are made to the method of regulation that increases uncertainty and/or reduces transparency.

¹ Levy & Spiller quoted by Farrier Swier, p49.

For EnergyAustralia the potential for arbitrary decisions under the building block approach exposes the business's significant asset base and capital expenditure program to the risk that such investment may not deliver a return to the business. EnergyAustralia has been given little guidance by the regulator as to how the roll-forward of assets and capex will be treated at the next regulatory review. EnergyAustralia faces substantial risk because of a lack of policy that exposes its business to the potential for adverse revenue outcomes if significant investment, deemed prudent based on the best available information, is not recognised or if the remnants of the revenue cap in NSW are not addressed in an appropriate manner at the next pricing determination. Without comfort in these matters into the future, EnergyAustralia faces a significant disincentive to invest.

EnergyAustralia believes that regulators are often reluctant to articulate specific policies for fear of binding future regulators. The absence of a national framework on regulatory policy in energy markets means that jurisdictional regulators are able to develop their own interpretation of regulatory instruments which leads to uncertainty and in many cases, inconsistency. While the flexibility in interpretation can be put to good use in the right circumstances, it also produces unnecessary risk.

EnergyAustralia believes that a national policy framework should be established through the CoAG auspices to address the reluctance of regulators binding future regulators. Where jurisdictional policies align with the national policy regulators will have greater comfort in committing to policies for longer periods of time and this in turn will provide greater certainty for regulated businesses and allow appropriate investment incentives to develop within the existing framework.

The recent decision by the Western Australian Supreme Court relating to Epic Energy provides some comfort to regulated businesses that within the current regime regulators must take matters of financial viability into account. EnergyAustralia believes that a significant change in the regime at this time, such as the move to an "unlinked" approach, will undermine any comfort generated by the Epic decision. In fact, a change to the regime will do nothing to address fundamental problems that exist, and that will continue to exist, should a new and less transparent regime be introduced.

Establishing Po

Farrier Swier advised that in an unlinked approach to regulation, Po is established and indexed using one of a variety of indexes. Farrier Swier also outlined that the building block approach could be used to establish this starting point. EnergyAustralia believes it would be inappropriate to use the building block approach to establish Po while there are numerous problems already identified within the current framework. A decision to proceed without addressing these fundamental issues would lock in these deficiencies indefinitely.

Farrier Swier mention in the report that errors in setting Po can be picked up by using off-ramps (higher and lower bounds) that signal the need for a new cost based review. From EnergyAustralia's perspective this argument is simplistic and does not take into account the potential damage to network investment that could occur between the time Po is set and the time the problem has become sufficiently serious to trigger a review².

² The breadth and timing of the "off-ramps" could potentially involve hundreds of millions of dollars before being triggered and take substantial time to unravel. Problems in the current network

EnergyAustralia sees no value in locking in current and clearly identified deficiencies. Therefore, EnergyAustralia is not supportive of any wholesale changes to the framework of regulation until greater certainty on investment issues is reached within the current framework. Only then will regulated businesses be able to make long term investment decisions based on the right incentives within both regulatory methodologies.

Benefits of a new regime

It is not clear to EnergyAustralia that the potential benefits of moving to a different framework will be greater in magnitude than the potential benefits of refining the current framework at this time. Farrier Swier argue that a different framework has the potential to reduce regulatory costs to the industry but this needs to be considered in the context of one-off transaction costs that will be incurred in the move from one framework to another. From EnergyAustralia's perspective, until there is a clear case that the deficiencies in the current framework are significant enough to outweigh the transaction costs and potential risks associated with a new framework, we are not convinced that this issue is one that should be given serious consideration. Furthermore, a new framework comes with a new learning curve and potentially increases rather than reduces the scope for arbitrary decisions. In fact, Energy Australia is of the view that resources spent investigating market developments that are at least 10 years away could be better directed at addressing inadequacies in the existing framework.

That said, EnergyAustralia is not opposed to an unlinked approach to regulation in principle at some time in the future.³ EnergyAustralia believes that the unlinked approach could ultimately provide better incentives to businesses and could potentially reduce the costs of regulation. Given the upcoming move in NSW to a weighted-average price cap and uncertainty regarding asset valuation and roll forward, EnergyAustralia believes that at least five years will be needed to better understand investment incentives under the current framework, once they become more transparent.

At the subsequent review (i.e. 2009) the current approach should be maintained but a parallel test of an unlinked approach could be undertaken. This would result in 10 years of history under a more refined building block framework, combined with some history of how the unlinked indexed prices would have compared over an appropriate period.

Information for TFP

The Farrier Swier report recommended that a decision be made sooner rather than later to pursue a TFP approach and that information should be gathered to form an appropriate index to be used when it is introduced.

As noted above, EnergyAustralia does not believe it is appropriate to make the decision to pursue a TFP approach at this time. However, EnergyAustralia is not opposed to the suggestion by Farrier Swier that a TFP approach be used in parallel as a "sanity check" within

determination have proved obdurate and have created substantial carry over problems into the next determination.

³ The Productivity Commission in its Inquiry Report: Review of the National Access Regime (28 Sept 2002) made the recommendation (no 12.2) that the Commonwealth and State Governments should progress through COAG the development of productivity measurement and benchmarking techniques. This could facilitate regulators making greater use of productivity-based approaches to setting access prices.

the current processes. But this support is provided on the basis that the index does not place additional costs on businesses through further information reporting requirements at the current time, given the already significant costs facing the business in complying with existing regulatory obligations and in preparing for a major pricing determination.

Changing attitudes to returns

As a final point, EnergyAustralia agrees with Farrier Swier's comment that an unlinked form of regulation is not likely to be sustainable until regulators are comfortable with businesses earning a higher than average return during some years, and the businesses themselves are comfortable with their potential to earn lower than average returns in other years. Until the investment signals and incentives are addressed within the current framework neither businesses nor regulators will feel comfortable that an unlinked approach can produce a sustainable and successful approach to regulation.

I trust that these comments are helpful to the Utility Regulators Forum's assessment of the Farrier Swier report on the future of regulation for network businesses. I would be happy to meet with members of the Forum to discuss the contents of this submission and can be contacted on (02) 9269 2111.

Yours sincerely,

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Managing Director