

**CitiPower Response to the
Productivity Commission's Position
Paper - Review of the National Access
Regime**

CitiPower 30 May 2001

Introduction

CitiPower commends the Productivity Commissions Position Paper for its objective focus on improving regulatory processes and competition policy in Australia. CitiPower is particularly pleased to note the Commission's Finding 8.1 that "Greater use of productivity-based approaches for setting price caps...would be desirable. Regulators should give priority to developing the external benchmarks necessary to implement such approaches".

CitiPower's comments are primarily made in response to the Productivity Commission's discussion on incentive-based regulation. In particular, this response makes suggestions that are likely to address the limitations that are perceived in relation to implementing productivity-based approaches. These mainly revolve around the reluctance to decouple costs from prices during transitional periods and ongoing concerns in relation to returns by some investors, regulators and customers.

CitiPower recommends that serious consideration be given to Earnings Sharing Mechanisms (ESMs) as a way of dealing with transitional issues. ESMs used in conjunction with TFP approaches can simultaneously maintain the underlying integrity and benefits of external regulation, address transitional concerns, and avoid fundamental re-examinations of utility cost. Given the potential for ESMs and its long history of use in other jurisdictions, CitiPower cannot agree that fundamentally "cost-based approaches for setting prices will be required at least periodically" (PC p 215).

Regulation Must Promote Long-Run Customer Benefit

One of the most valuable aspects of the PC report is its focus on the long run. Long-run considerations are often discounted because of the short-term pressures on regulators and politicians to "show results" from utility sector reforms. Inevitably, reforms are seen to be working if they lead to immediate and substantial price reductions

for customers. While consumer welfare is naturally important, regulation must also provide the correct incentives for investment and innovation. If regulation promotes short-term customer gains at the expense of investment and dynamic efficiency, consumers may actually be worse off in the long run.

Regulatory policy must always be cognizant of long-run impacts, which are invariably tied to the development of utility industries. To promote the most efficient utility structures, competition should be introduced wherever it is feasible. Services that remain subject to regulation should be provided as efficiently as possible. In addition, regulatory arrangements should facilitate evolution and maturation in competitive markets.

CitiPower has long argued that these goals are best advanced by external regulation utilising productivity-based approaches to price setting (eg TFP). External regulation creates maximum performance incentives. This is true for both short- and long-term utility operations. External regulation is also more compatible with competition than alternative regulatory approaches. As we have noted in other publications, external regulation allows for flexibility in various ways that promote effective competition.¹ External regulation can also allow DBs to facilitate market maturation by appropriately deploying distributed generation and “smart” meters and undertaking market-responsive DSM. A greater DB role in these areas leads to greater diversity of demand- and supply-side resources in competitive markets. In addition to encouraging market dynamism more generally, these developments will promote efficiency and customer benefit by simultaneously maximising the role for price signals and enhancing the options available to customers to manage demands and their exposure to possible short-term price volatility.

CitiPower believes that these long-term benefits are only likely to be realised under external regulation. We therefore reiterate the importance of external regulation as a long-term regulatory goal.

¹ For example, see *Incentive Regulation, Benchmarking and Utility Performance: CitiPower's Response to the Utility Regulators Forum Discussion Paper*. CitiPower will be publishing a further paper titled, “Operationalising TFP Approach to Regulation” in June 2001.

Possible Transition Mechanism to Long-Term Goal

While it is important not to lose sight of the best long-term regulatory model, transitional regulatory arrangements may be desirable in the interim. Some regulators may not be immediately comfortable with external regulation for a number of reasons. For example, they may not be familiar with how external regulation operates in practice. Some may also believe they have an ongoing obligation to examine company costs, even after an initial cost of service review. CitiPower recognises this reality and believes that there is value in exploring mechanisms that allay regulators' concerns and increase their comfort in transitioning to more delinked approaches.

One important transitional vehicle may be an earnings-sharing mechanism (ESM). An ESM would appear to be compatible with the PC objectives since it does check prices against costs rather than set prices directly. ESMs can also be structured to provide downside earnings protection (thereby erring on the side of investors) and still create incentives by allowing higher returns for more efficient companies. At the same time, an ESM will tend to keep returns in a politically acceptable range, which can reduce pressures on regulators and promote a more light-handed regulatory approach. ESMs can be used as either a stand-alone option or in combination with building block or productivity-based approaches.

There is a long history of ESMs in utility rate regulation. They were used in England as early as 1855 to regulate local gas companies. An early American plan was established in 1905 for the Boston Consolidated Gas Company. An ESM was also used to regulate the rates of Potomac Electric Power Company in Washington, D.C. from 1925 through 1955.

There is also an interesting history regarding the use of ESMs in North American CPI-X plans. North American regulators have relied extensively on external regulation when setting the terms of CPI-X plans.² Many of the earliest such plans also included ESMs. For example, the CPI-X plan approved in 1991 by the Federal Communications Commission (FCC) for Local Exchange Carriers (LECs) included a symmetric ESM (both gains and losses relative to allowed ROE were shared). One reason for this ESM is

² For details, see L. Kaufmann and M.N. Lowry, *Updating Price Controls in Victoria: Analysis and Options*, June 1997.

that the plan applied to eight different companies with service territories as diverse as New England and the Pacific Northwest. The FCC was concerned that regional economic growth and other conditions could vary across the companies and thereby influence the potential for productivity growth. The ESM was viewed in large part as a “backstop” which would reduce this risk.

At around the same time, several state commissions approved price cap plans for telecom utilities that included ESMs. Examples included California (Pacific Bell and GTE-California in 1990), New York (Rochester Telephone in 1991), Rhode Island (1992), and New Jersey (1993). In these cases, ESMs were viewed primarily as earnings-sharing devices rather than risk-reducing “backstops”.

Earnings-sharing mechanisms became rare in the North American telecom industry as price caps became the standard method of regulating telecom services. For example, the updated plan for the LECs subject to FCC jurisdiction did not include an ESM. ESMs have also become rare on the state level. Of the more than 25 states that currently use indexed price caps to regulate the dominant LEC, only one (Florida) includes an ESM. In place of ESMs, regulators have chosen to share benefits with customers through “consumer dividends” that are incorporated in X factors.³ This experience lends support to the view that ESMs can be useful for transitioning to a more delinked, external regulatory approach.

There are both advantages and disadvantages with using ESMs in network regulation. One clear disadvantage is that ESMs can weaken incentives for cost cutting and marketing. Utility managers clearly have less incentive to undertake such efforts if doing so leads in part to price reductions. ESMs can also raise concerns about discounting and other methods of marketing flexibility since the revenue “losses” may be recovered from remaining customers. Because of these concerns, marketing flexibility may be restricted. A continued focus on earnings also maintains the potency of inherently controversial issues like utility-affiliate transactions and cost allocations between regulated and non-regulated services. Regulatory attention to these issues can

³ ESMs are also common in CPI-X plans for North American energy utilities. However, these plans are less prevalent for energy utilities, so there is much less history regarding how ESMs have evolved.

both discourage profitable diversification and impose regulatory costs through ongoing monitoring and evaluation. These have been major concerns for telecom utilities and are partly responsible for the lack of ESMs in telecom price cap plans.

Notwithstanding these problems, earnings sharing has some important potential benefits. It is a predetermined and automatic means of adjusting prices for a wide range of external developments that could otherwise be perceived to produce windfall gains and losses for the utility. By mitigating the potential for windfalls, earnings sharing can extend the time period during which the utility can operate without a regulatory review. The extension of regulatory lags in principle have a positive effect on incentives that more than offsets the negative incentive effects of the sharing itself.

ESMs also have features that make them attractive in regulatory processes. One is that they are relatively simple and easy to understand. They also clearly align the interests of shareholders and customers, and their benefits appear to be transparent and easily computed (*i.e.* the amount of additional utility earnings distributed to customers or retained by shareholders). ESMs will also, by design, keep utility earnings within politically acceptable bounds and hence may build consensus among parties to a regulatory review. For all of these reasons, ESMs may be viewed favourably in terms of fairness.

CitiPower believes ESMs deserve serious consideration in the present environment. ESMs are generally compatible with the PC objectives yet have received little attention. ESMs may also play a valuable role in improving Australia's regulatory environment and facilitating the transition to light-handed regulatory approaches that promote the greatest long-run consumer benefit.

No Need for "Cost-Based Resets"

In addition to transitional issues, another issue involved in implementing price controls is what information and methods are used to update controls. One of the findings of the Position Paper is that there should be greater reliance on productivity-based approaches. However, the Paper also says that these approaches should be used "at least in periods between cost-based 'resets'."

CitiPower believes that this last statement is unnecessary and potentially harmful. Productivity-based approaches, when done properly, eliminate the need for “cost-based resets.” CitiPower does not object to setting rates at the outset of the *initial* price controls using cost of service methods. This step can enable price controls to begin from a proper starting point. As stated above, lingering concerns with utility returns are also better dealt with using ESMs rather than reverting to fundamentally cost-based approaches at regulatory reviews. However, we believe it is important to emphasize that, even if political considerations lead to constraints on allowed returns, utilities exhibiting superior performance should be allowed to earn superior returns. This is consistent with the operation of competitive markets, where firms that exhibit superior performance are able to maintain higher returns on an ongoing basis.

We also believe it is counterproductive to use measures such as industry TFP trends to adjust rates between reviews but to use company costs to adjust rates at reviews. Regulatory resets of this kind considerably diminish the benefits associated with TFP-based approaches. Cost-based resets introduce all of the information-intensive, intrusive regulatory processes correctly emphasized in the Paper. Moreover, regulators employing “cost based” approaches invariably want to ensure that company costs that are the basis of prices are “reasonable” or “efficient” in some sense. The ways in which these concepts are applied at the review are often unclear and/or arbitrary. CitiPower therefore believes that, in practice, cost-based regulatory approaches are not necessarily objective or precise. This is in contrast with the Position Paper’s statement that “productivity-based approaches inherently involve less precision than cost-based approaches.”

Benchmarking

CitiPower does not concur entirely with the views of other submitters on the relative merits of benchmarking. We acknowledge the challenges involved in benchmarking and agree that some benchmarking studies offered in Australia have been problematic. However, we believe that appropriate benchmarking may still play a role in regulation. There are many issues related to benchmarking methods and applying benchmarking in regulation that are too complex to be addressed here. We refer the Productivity Commission to a recent paper commissioned by the National Electricity

Distributors Forum, *External Benchmarks, Benchmarking, and Power Distribution Regulation: A Critical Evaluation*, that addresses these issues and will be forwarded to the Commission under separate cover.

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30 May 2001