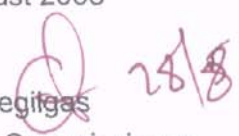


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25 August 2003


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Dear Alan

SUBMISSION ON 2004 REGULATORY RESET

The Essential Services Commission of South Australia (ESCOSA) has reviewed the Utilities Commission 2004 Regulatory Reset Issues Paper. ESCOSA is pleased to provide the following response to some of the matters raised in your paper. The views expressed below reflect ESCOSA's experience from a general regulatory perspective, and more specifically from our work so far in the South Australian reset process for electricity.

General observations

The overall task for the Utilities Commission is the selection of an appropriate form of regulation. ESCOSA has undertaken some development work in this area as we face the same issue from time to time and in respect of varying industries. In a general sense, ESCOSA has found that the following four criteria serve as a useful generic base when assessing forms of regulation:

- ▲ the power of the incentive mechanism – which considers both whether a form of regulation can provide strong incentives and whether the industry being assessed requires, or can respond to, incentives;
- ▲ regulatory risk – which considers the likely consequences of over and under regulation;
- ▲ information and administration costs – which considers whether the necessary information is available and whether the industry, or market power concerns within it, warrant the various costs that regulation will impose; and
- ▲ robustness to change – which considers whether the form of regulation selected will be able to keep up with industry and market dynamics, or indeed, whether it would stifle them.

Naturally the weighting to be applied to each would depend upon the various legislative constraints faced. Furthermore, the Utilities Commission would need to be satisfied that any criteria selected were consistent with its own legislative objectives.

As the Utilities Commission paper sets out, the scope for choice of form in electricity is limited by legislation. However, the Utilities Commission could elect to examine the remaining options against general criteria, such as those listed above, and then against any specific additional legislative obligations. ESCOSA has done this in its review of ports price regulation and expects to use these criteria in respect of regulatory decisions in gas and electricity, although legislative constraints mean that ESCOSA has not engaged in consultation on forms of regulation for prescribed electricity distribution services.

Specific responses

ESCOSA has identified three areas from the Utilities Commission Issues Paper for specific comment.

Issues 3 / 4: Assessment Criteria

Appropriate assessment criteria for a form of regulation decision will depend on the relevant legislative objectives that the regulator must meet – the criteria selected should flow directly from those objectives.

If consistent with the legislation it would also be desirable to seek appropriate consistency with regulatory practices in other jurisdictions. However, this should not be pursued at the expense of the best choice for the Northern Territory. ESCOSA agrees that the most appropriate criteria would include consideration of the particular characteristics of the Northern Territory electricity market.

This would most likely include consideration of forms of regulation appropriate to the scale of the market being regulated – essentially running a cost/benefit test over more complex arrangements to ensure that the pursuit of 'regulatory precision' (or regulatory consistency) does not create more cost than any benefits it might generate.

Issue 13: Efficiency Carryover

ESCOSA has recently considered the efficiency carryover issue as part of its Electricity Distribution Price Review process, and has published Working Conclusions on this matter¹ ESCOSA has proposed a system of rolling carryovers, allowing the regulated business to retain efficiency gains or losses for 5 years from when they are made, thus providing a continuous incentive.

This approach raises the issue concerning carryovers into the regulatory period subsequent to the period under review. This involves the difficult trade-off between seeking to provide certainty over the longer term, and making decisions that bind future regulators.

ESCOSA formed this view that while it may not be able to bind a future regulator, it could state a clear intention as to what it felt should occur. ESCOSA also formed the general view

¹ Electricity Distribution Price Review: Efficiency Carryover Mechanism. Working Conclusions. April 2003.

that there would be little incentive for a regulated business to achieve efficiencies in the next period if there was little certainty over how they would be treated. Hence the Working Conclusions state ESCOSA's intention as to what should happen to those efficiencies.

Issue 15: Price Signaling

Cost reflective price signals can provide efficiency benefits in so far as they create an incentive for consumers to modify their consumption patterns in response. However, ESCOSA observes that the extent to which this occurs is limited for many consumers, especially households, which tend to display very inelastic energy demand. The potential benefits from cost reflective price signaling should be seen in context.

Furthermore, it is uncertain whether cost reflective distribution tariffs would be passed through in the same manner to retail tariffs – thus undoing efforts at the distribution level.

Conclusion

I would be pleased to discuss any related matters with you further if you so desire. Please call either myself or Rajat Sarawat, Director Pricing and Access at ESCOSA, on 08 8463 4444. I would also like to bring to your attention the various Discussion and Working Conclusion Papers that we have published in respect of our 2005 Electricity Distribution Price Review.

Yours sincerely



Lewis W Owens

CHAIRPERSON