Draft Decision
Access Arrangement Mid-West and South-West
Gas Distribution Systems
Comments on Regulation

Asset Valuation

The massive asset write-down (from approximately $700m to $510m) taken by AlintaGas is of some concern. The fact that the initial asset base value has been set to allow a positive retail margin for the current retail tariffs suggests that retail tariffs are unsustainably low.

Unless the asset base is written down to the same extent at each full regulatory review, it is difficult to see how the access prices can continue to trend down in real terms. If assets are perpetually written down then the Service Provider will not be able to afford to replace the existing assets. This appears to be a significant risk to the service provider.

Whilst Western Power understands that the current Regulator is unable to bind future Regulators or decisions (except through Fixed Principles), Western Power considers it would be appropriate for the Regulator to state in the Final Decision that:

- the large initial asset write down is made for specific retail profitability outcomes and does not represent the optimal long run asset base nor equitable nor efficient pricing outcome for the Service Provider; and

- future asset write-downs are appropriate only when the new investment fails to pass technical or economic efficiency tests.

Average Revenue Yield Regulation and Tariff Re-balancing

The Regulator argues that Average Revenue Yield regulation provides the Service Provider with an incentive to "game" tariffs to limit the ability of competitive retailers to compete within certain segments of the market.

It appears that the Regulator recognises the benefits of Average Revenue Yield regulation but, on balance, considers that these benefits are outweighed by the potential for AlintaGas to manipulate tariffs to benefit their own retailer. Manipulation of tariffs can occur either:

- at the outset, when tariffs are set for the start of the regulatory period, or
- at the annual re-setting of tariffs under the guise of re-balancing.

The ability to "game" initial tariffs has been effectively prevented by the requirement to set network reference tariffs to allow for a 2% retail margin in all cases.

The ability to "game" tariffs as part of the annual tariff re-set is limited by the side constraints on price movements (Y control), threat of bypass and asset write-downs. The side constraints can be set to allow any desired level of flexibility in this re-balancing.

The Regulator has suggested that the way to prevent tariff gaming is to move away from Average Revenue Yield regulation to Tariff Basket / Price Cap regulation. Any tariff re-

balancing would be done under the oversight of the Regulator. The problem with this outcome is that the potential benefits of revenue yield regulation are lost.

Western Power submits that incentives, rather than re-balancing, is the characteristic feature of Average Revenue Yield. The benefits of Average Revenue Yield regulation, over Tariff Basket / Price Cap regulation, are centred on the creation of incentives for the Service Provider to find ways to improve the utilisation of the network with the long-term benefit of lower network prices for all customers.

The Regulator's decision regarding the appropriate amount of re-balancing can be treated independently from the form of regulation (Average Revenue Yield, Tariff Basket / Price Cap, Revenue Cap or other). An Average Revenue Yield regime can be implemented with no re-balancing (by setting Y equal to -X) or unlimited re-balancing (Y infinite) or anything in between. Re-balancing could also be allowed under Tariff Basket / Price Cap.

Strategic re-balancing of access prices to maximise the value of the Service Provider's retail business is a real problem but it applies to both Tariff Basket / Price Cap and Average Revenue Yield and can be relatively easily handled within either regime.

If the Regulator believes there is a risk that the Service Provider may set inefficient prices, the Regulator could retain Average Revenue Yield regulation and limit or completely remove the ability to re-balance tariffs. This could include the requirement, as suggested by the Regulator, that any tariff re-balancing be fully scrutinised by the Regulator. This option would allow some of the benefits of Average Revenue Regulation to be retained, while meeting the Regulator's concerns regarding tariff re-balancing. Western Power does not consider it appropriate to choose Tariff Basket / Price Cap over Average Revenue Yield on the basis of re-balancing restrictions.

Advantages of Average Revenue Yield

Western Power submits that the major difference between Average Revenue Yield and Price Cap / Tariff Basket is the incentives the regimes provide to the Service Provider (not the ability to re-balance tariffs).

Because there are not usually significant elasticity differences between classes, it is possible to overstate the efficiency differences between the regimes and to understate the incentives differences of the regimes.

Under Price Cap / Tariff Basket, the Service Provider's incremental revenue is related to the average cost of supply for that tariff class. Under Average Revenue Yield, the Service Provider's incremental revenue is related to the average cost of supply for all tariff classes. That is, compared to Price Cap / Tariff Basket, Average Revenue Yield provides higher incentives to grow off-peak throughput and lower incentives to grow peak load. In practice this means:

- Because Price Cap / Tariff Basket, provides a relatively homogenous incentive to grow load across tariff classes, the Service Provider is happy to add more capacity to meet peak load growth. By comparison, Average Revenue Yield provides greater incentives to provide alternative and innovative solutions to meet peak load growth.

- Under Revenue Yield, Service Providers have strong incentives to improve asset utilisation.

- Under Price Cap / Tariff Basket, the incentive to grow a particular tariff class depends on the difference between the specific tariff level and the incremental cost of supply for that tariff class. The incremental cost of supply is difficult for the Regulator to assess – therefore it is difficult to determine exactly what incentives have been provided to the Service Provider. The Regulator is relatively uncertain which tariff classes are most attractive to the Service Provider and therefore whether the incentives are desirable or efficient.

Compared to the Price Cap / Tariff Basket, Average Revenue Yield provides simple, well understood (by Service Provider, Regulator and Government) incentives, namely sell more (particularly off-peak) service and improve asset utilisation (flatten load profile).

Western Power concludes that the practical, simple incentives of Average Revenue Yield outweigh the theoretical efficiency advantages of Price Cap / Tariff Basket.

Tariff Re-balancing and Efficiency

In the previous sections we have argued that:

- allowing tariff re-balancing is an independent decision to the choice of regulatory control (Average Revenue Yield or Tariff Basket / Price Cap); and

- even without re-balancing, Average Revenue Yield provides superior incentives for the Service Provider (and therefore lower prices for customers in the long run).

This section argues that, if re-balancing is allowed, Average Revenue Yield is likely to facilitate efficient tariff re-balancing.

The Regulator argues that Average Revenue Yield regulation provides the Service Provider with an incentive to reduce prices, for some segments of the market, below economically efficient levels (i.e. below the long run avoidable cost of providing the services), in order to increase overall throughput (as more throughput increases revenue and profit).

Whilst this is a theoretical outcome of Average Revenue Yield regulation, Western Power does not consider that it is a practical problem.

To arrive at an undesirable re-balancing outcome, two initial conditions must be met:

- the Service Provider must identify classes of consumer with very different elasticity's of demand; and

- prices must already be efficient in level and structure.

Neither of these conditions is usually met by allocated average cost of service pricing methodologies.

If the first condition is not met, then there is no practical problem – the Service Provider cannot increase throughput by re-balancing tariffs.

If the first condition is met, then the re-balancing ability will generally increase efficiency. Because prices are initially set based on an average allocation of the cost of service and, in AlintaGas' case, retail tariff level and structure, the initial access prices are likely to be

inefficient. By decreasing the price to highly elastic classes and increasing the price to relatively inelastic classes, the Service Provider will both increase revenue and efficiency.

It is only in the extreme, where the price is reduced to a level below the marginal cost of supply for that class, that prices become inefficient. However, there are several factors limiting the extent of this game including:

- CPI+Y re-balancing constraint makes it difficult to develop cross subsidies during a single Access Arrangement;

- the threat of asset bypass for the cross-subsidising class limits the amount of cross subsidy available; and

- the potential write down of assets supplying a low charge class at next regulatory review (when a new cost of service assessment is conducted) reduces the incentive for the Service Provider to charge less than the long run avoidable cost for use of assets.

Western Power concludes that, if tariff re-balancing was allowed under an Average Revenue Yield regime, the resulting tariff changes are likely to be efficient.

Administrative Complexity

The Regulator argues that the proposed Average Revenue Yield regime introduces significant regulatory complexity because the Regulator will be required to devote resources to:

- verify whether quantity forecasts are reasonable (the Regulator argues that the Service Provider has an incentive to strategically bias forecasts); and

- audit K-factor correction mechanism.

Western Power submits that it is possible to remove forecast quantities from the Average Revenue Yield regime by using historic service mix to weight forecast sales between tariff classes.

In general, in any regime, higher administration costs must be weighed against superior incentives for Service Providers and outcomes for customers.

Historically, Western Australia operated gas and electricity businesses without a Regulator. The recent addition of an independent Regulator increases administration cost to government and industry. However, we assume that the introduction of the Western Australian Gas Regulator improves outcomes for customers.

The goal should be to optimise the regulatory activities and scrutiny rather than minimise the Regulator's workload. For example, it may be more appropriate to rely on targeted audits rather than detailed analysis of every proposal.

Determination of the X Factor

Determination of the X factor should be consistent with the method of regulation.

The Regulator has indicated the possibility of applying a premium to the X factor to force additional efficiencies beyond those incorporated in the forecast capital and operating budgets for the regulatory period. The Regulator has indicated that the forecast capital and operating expenditures will be reduced to levels that may be regarded as consistent with efficient costs. This action has imposed a requirement on AlintaGas to reduce its capital and operating costs to levels below those forecast just to meet its forecast profitability.

A further increase in the X factor will make it more difficult for AlintaGas to achieve efficiencies that would be rewarded under an incentive regime. Remembering that the essence of incentive regulation is that the greater the incentives, the greater the long-term savings and the greater the customer benefits. On this basis, an additional premium on the X factor appears counter productive.

Regulatory Intrusion

It has been stated several times that the Regulator favours light-handed regulation. Western Power's understanding of light-handed regulation is that it focuses on outcomes for customers rather than inputs to the network business, and uses audits from time to time to determine whether the network business behaviour is appropriate.

The approach in the draft proposal is tending towards a more heavy-handed approach with rigorous scrutiny of inputs prior to implementation. Western Power believes that light-handed regulation leads to the most efficient long-term outcomes for customers and reduces the regulatory burden for all.