

# Network Regulation Rule Change Forum

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# Outline

- US regulation – original approach
- UK regulation Ofgem stage 1
- UK regulation Ofgem stage 2
- UK regulation Ofgem stage 3
- Customer engagement at Ofgem
- Negotiated settlements in US
- Constructive engagement at CAA
- General conclusions
- Implications for Australia/AEMC process

# US regulation

- Where it all began? Over 100 years now
- Capex used & useful, prudently incurred
- Fair and reasonable return on capital
- Regulatory reviews are simpler than UK/Australia - not forward-looking
- But still onerous & risky – companies & regulators prefer to avoid reviews
- Hence move to pass-throughs, pre-approvals & negotiated settlements

# UK incentive regulation

- RPI-X incentive price cap, typically 5 years
- Had different main aim: efficiency
- Has proved very effective at incentivising reductions in operating costs & prices
- Companies also have incentive to minimise capex - over-runs not a problem
- These incentives work well for private cos
- Is incentive regulation applicable for public cos? An important question in Australia

# Ofgem stage 1

- How to set price caps?
- Parallel work processes
  - Company projections and bottom-up reviews of these by regulatory consultants
  - Benchmarking with other companies
- Regulatory challenge – debate - iterations
- Regulator proposes price control based on own judgement of efficient capex & opex

# Ofgem stage 1 contd

- Process flexible – no rules, contrast Austr
- Regulator can reject company arguments
- Proposals typically more challenging than company projections, both capex & opex
- What keeps regulator reasonable?
- Has to convince CC if company rejects
- Both company and regulator wish to avoid hassle, cost and risk of CC reference
  - Note risks for companies too, unlike Australia

# Ofgem stage 2

- Benchmarking becoming more effective
- But the process is increasingly onerous
  - Arms race in terms of techniques & comparisons, econometric work etc
  - Standardised cost allocations prescribed
- Regulator also seeks incentives to forecast capex reasonably and realistically
- As alternative to direct challenge at CC
- Hence evolution of menu regulation

# Menu regulation

- Companies can choose preferred capex
- But allowed return is lower the further their achieved position is from their forecast, hence incentive to forecast reasonably
- And return is lower the further their chosen position is from Ofgem's preferred capex
- Ofgem found it a useful way through 2004 control price control review, & retained it
  - Requires more flexibility than present Rules allow?

# Ofgem 3

- New regulatory world emerging 2010+
- Old assumptions no longer apply
- Future technologies & needs unknown
- But network opex & capex likely to be costly
- Also increases in generation & retail costs
  - RIIO – Revenue for Incentives, Innovation & Outputs
- Customers can provide views? Better for all if customers are onside from the beginning?
- Hence move to more customer engagement

# Ofgem 3 in practice

- Companies that have a good customer engagement process and customer approval of business plan to get fast track
  - Next transmission price control – 2 fast track, 2 slow
  - Though to date reflects proposed customer engagement rather than actual engagement
- Note Ofgem not ceding control to customers
- Application to distribution networks with millions of customers as yet unexplored
  - But underway in Scottish water sector price control
  - Customer Forum created + access to regulatory info
  - Could be possible in Australia too?

# Settlements in US

- Settlements common in US since 1960s
- Short-cutting standard procedures
- Parties already involved in & familiar with traditional regulatory litigation process
- Outcomes similar but mutually beneficial (otherwise one party could refuse)
- Better meet preferences of the parties
- And often more innovative than regulation

# Role of regulator

- Regulator plays little role in some cases
  - Eg Florida, where settlements driven by Office of Public Counsel
- But very proactive in other jurisdictions
  - Eg FERC where staff prepare initial analysis of company proposal that is basis for discussion
- Smaller customers are represented
  - By customer groups (eg large industrial users)
  - Statutory bodies (eg Attorney General Office)
  - Staff of regulatory bodies themselves
- Information, resources & process important

# Constructive engagement at CAA

- CAA regulates airports, sets price controls
- Dissatisfied with adversarial process
- Proposed that airports & airlines discuss & seek to agree specified elements of control
  - Traffic forecasts, quality standards, capex plans
- CAA would accept, do rest of price control
- Against expectations, this worked
- Parties agreed better than previous process

# CAA going forward

- Air traffic control review: process improved
  - more explicit timetable, mutual information obligations, progress reports
- New price control process now underway
  - Parties designed & agreed processes at each airport
  - All aspects of price control on table for agreement
  - Main regulatory role initially re transparency of data
  - Encouraging commercial agreements, not just inputs to traditional price control
  - Need for resources? Or better communication instead
- Australian airport regulation goes further
  - Commercial agreements under threat of re-regulation

# General conclusions

- No single best method of regulation
  - Incentive regulation has been very effective in UK
  - But there is also a continual process of experimentation to address problems encountered
  - Discovery process, much learning from experience
- Increasingly, the trend is to facilitate parties themselves negotiating agreements
  - Parties plus regulator have incentives to improve on costly & severe standard regulatory process
  - Negotiations reflect accepted process, information provision & adequate representation for all customers

# Implications for Australia/AEMC

- Generous regulation a factor in elec price increases
- Regulatory flexibility & innovation important – reduce/remove undue restrictions in Rules
  - Menu regulation and RIIO not necessarily best way
  - Devise methods of regulation suited to Australia
- Importance of discipline on cos & regulator – need appeal mechanism in Austr where both sides at risk
- Customer engagement possible in Australia if incentives on companies via effective regulation
- US & UK experience is for private cos
  - Is Australian framework – or any regulation – applicable to public companies with different incentives & costs?