

March 14, 2013

Mr Philip Weickhardt  
Presiding Commissioner  
Productivity Commission  
Locked Bag 2, Collins Street East  
MELBOURNE VIC 8003

Dear Mr Weickhardt

In its 25 February DR104 submission, I note that the Australian Energy Regulator (AER) has said that it intends to move to a revenue cap form of incentive regulation. I wish to draw your attention to the fact that this issue was comprehensively reviewed by the Essential Services Commission in Victoria and, before it, by the Office of the Regulator-General in Victoria. While there is no need to reprise all the arguments in support and against revenue caps, in my opinion a move towards blanket, industry-wide revenue cap regulation would be a significant step backward.

The practical issues highlighted in AER's submission result directly from the cost of service/building block model that has become entrenched in Australia. A true productivity-based approach, combined with allowed pricing flexibility for distributors, would create powerful incentives for energy utilities to price efficiently in order to maximize their profits. Glomming revenue caps onto a cost-based, building block regulatory model would do nothing to rectify the underlying deficiencies of that approach.

Implementing revenues caps would also have serious long-term consequences for Australia. Under the current regime, distributors are already incentivized to maximize their revenue by building rate base. Revenue caps would not undermine these incentives, but only impact how allowed revenues are collected through various billing determinants. By allowing revenue losses to be recovered through higher volumetric charges, revenue caps would exacerbate the upward price pressures that Australian customers have already experienced for network services.

A different regulatory regime – the one originally envisaged by the Victorian architects of reform – would in time encourage distribution companies to diversify efficiently and produce value-added services that customers want. This type of market-based approach would lead to rational and cost-effective energy conservation. Australia should stay the course and pursue other, more worthwhile regulatory reforms, not be tempted to repair a dysfunctional building block model with a never-ending stream of ineffective patches.

Yours sincerely

Larry Kaufmann, Senior Advisor