

Competition a loser in price regulation lottery

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As consumers we all grumble about price rises.

For most goods and services, competition means rivals will undercut suppliers that try to raise prices above costs. But where there is a single monopoly supplier these restraints don't apply.

Monopolies are rare. They exist either where governments prevent new competition or, as with gas pipelines and electricity poles and wires, where there can be only one supplier.

Governments either nationalise or control the prices of such "natural monopolies". Nationalisation is nowadays avoided. Bitter experience shows that government-owned firms soon become high-cost outfits showing little innovation.

Pricing for gas and electricity is an important role for regulators.

In 1990 Victoria's state-owned gas industry had a bloated workforce of 5000 and over-engineered "gold-plated" facilities. Under private ownership, the workforce has been reduced to just a few hundred and there has been greater discipline in capital spending. As the Essential Services Commission has shown, this has brought lower prices while maintaining service standards.

This greater efficiency of private ownership has led governments throughout the world to prefer it over state ownership.

But determining the right price without competition presents real difficulties whether or not the service is government-owned. Government regulators in the past often set prices too low, which initially favours customers but eventually leads to service deterioration.

Classic examples were the US and European rail systems which a century ago saw regulators progressively reducing prices. This led to obsolete networks which could not compete with motor transport. Only with recent price deregulations has rail shown some recovery.

In contrast to that experience, the price regulation of gas and electricity in Australia has been handled well.

The regulators have required price reductions of businesses that had grown fat and lazy under government ownership. The businesses continued making healthy profits by cutting costs.

But at some stage, once all the fat is cut out, requiring further price reductions eats into efficiency. They cause firms to stint too much on investment and start avoiding expansions into new customer areas.

In recognition of this, the national regulator has recently handed down stable prices to the monopoly Victorian electricity and gas transmission businesses of SP AusNet.

By contrast, the state regulator, the ESC, has further reduced the allowed rates of return from prices for gas distributors. This is largely based on a view that previous settings over-compensated firms for gas demand reductions during market downturns.

The ESC's decision is well reasoned but regulatory price setting remains too much of a lottery.

It sometimes requires years to determine whether a regulatory pricing decision is right or wrong, though share price

movements offer some early guidance.

In this respect, the share market reaction was sober rather than exuberant following the decision on SP AusNet, indicating the national regulator's views were widely shared.

Concerns about regulatory price cutting zeal have brought new inter-governmental guidelines, which place greater emphasis on ensuring adequate returns to regulated monopolies.

Even so, regulation of gas pipes and electricity wires remains too focused on restraining profitability, the very incentive business needs in order to innovate and pursue efficiency.

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