Committee Secretary
Senate Select Committee on Electricity Prices

Last Wednesday's Financial Review reported on Ross Garnaut's comments to the committee regarding how rate of return regulation may result in increased electricity prices to make up revenue shortfall arising from falling demand for power.

In case the committee is unaware of a paper by the Commonwealth Treasury that is very relevant to such issues, I bring that reference to your attention: "*Financial Monitoring of Government Business Enterprises: An Economic Framework*", Treasury Economic Paper 14, AGPS, 1990. The Treasury paper refers to a paper of my own that is also relevant to these pricing issues: Mayo, W (1989), "Pricing for Capacity Utilisation with Public Enterprises", *Australian Economic Review*, 3rd Quarter, 16-24.

I have attached scans of three pages from the Treasury paper to give you a feel for its content.

Essentially the message from the papers is that the setting of soundly-based long-run rates of return is not a problem *per se*. But prices should be set on the basis of short-run demand and supply considerations (or pricing to utilise all of currently available capacity) – which, over a day or across different seasons, will result in variations in price at given capacity (peak-load pricing with its attendant requirement for smart meters). Short-run profit and rate of return relative to required long-run return then provide a signal to respond with increases or decreases in overall capacity.

Thus, increasing general demand at fixed capacity would see prices increase generally (still with daily and seasonal variations) and some price-induced reduction in demand. Overall result would likely be increased profit and rate of return relative to required long-run return signalling the need to expand capacity – with the aim of seeing pricing according to demand/supply considerations after the capacity change result in returns consistent with required long-run return. In these circumstances, pricing and capacity should simulate what might be expected in a fully competitive environment.

I hope these references may be of some use to the committee.

Wayne Mayo