

7 October 2015

By email

Mr Thomas Jones and Ms Jennifer Dean
Corrs Chambers Westgarth
8-12 Chifley Square
Sydney NSW 2000

Confidential and privileged

Dear Thomas and Jennifer

I refer to your email of 30 September 2015 in which you ask me to address the following two questions relating to Economic Insights' Final Report (**EI's Report**) and the ACCC's draft Final Access Determination (**Draft Decision**) for Domestic Transmission Capacity Services:

- 1) whether the ACCC's draft decision not to adopt a downward glide path for its regulated pricing over the term of the FAD is consistent with it being a credible tool for determining benchmark efficient pricing; and
- 2) whether the statistical significance of the service provider variable in EI's analysis is effectively addressed by the method proposed in the ACCC's draft FAD and how this issue has been addressed in other contexts.

I address these questions in this letter.

1. Downward glide path for regulated pricing

The issue of whether the pricing model should include a price trend is discussed in Section 4.3.4 of the Draft Decision. It is noted that "[S]ubmissions generally agreed that commercially negotiated prices were likely to change over the course of the 2015 FAD". Two possible approaches to estimating the time trend in prices on competitive routes are discussed:

- a) comparing the 2011 and 2014 datasets
- b) including the contract starting date in the econometric model.

Both approaches are considered to have shortcomings, and in view of this the ACCC has chosen not to use forward looking prices in setting benchmark prices.

If this view is maintained in the final decision, then it is clear that the benchmark prices will be higher than efficient prices, since they will be benchmarked against 2014 deregulated prices, not the deregulated prices that will prevail during the course of the 2015 FAD.

An indication of the extent of the upward bias can be gained by comparing the deregulated prices in the 2011 and 2014 datasets. The average price for services on deregulated routes declined by almost 30% between these two datasets, even though the average speed had almost tripled, and the average distance had increased by more than 20%. It is safe to say that a comparison of equivalent services between the two datasets would show a price decrease of at least 30% over the period. Hence a conservative estimate would be that deregulated prices have decreased by about 10% per year. Using a regression analysis of the combined datasets, EI also shows that “annual charges declined by approximately 10 per cent per year on the deregulated routes” (EI's Report p.33).

On the available evidence, a 10% per year decline in prices would seem to be a reasonable estimate of the trend in deregulated prices. However, because of the data and modelling difficulties discussed in Section 4.3.4 of the Draft Decision, the ACCC has decided not to apply a forward looking glide path for the benchmark prices. This decision is equivalent to choosing a time trend of 0% as the ACCC's best estimate of the trend in prices. This is surely overly cautious and is bound to be an upwardly biased estimate of the trend in deregulated prices. In other words, the ACCC draft decision sets benchmark prices at the level of 2014 deregulated prices, which are considerably higher than the deregulated prices that are expected to pertain during the period of the FAD. Indeed, if the 10% annual decline in deregulated prices continues to the end of the FAD period, the benchmark prices will be about 65% higher than the deregulated prices.

In view of the above considerations, I conclude that the ACCC's draft decision not to adopt a downward glide path for its regulated pricing over the term of the FAD is *not* consistent with it being a credible tool for determining benchmark efficient pricing.

2. Service provider variables

The ACCC's preferred econometric model for benchmarking includes a set of dummy variables to capture differences in prices between the different service providers. EI's Report (p. 50) states that these “provider-specific fixed effects may reflect differences in efficiency, product differentiation, market power, or possibly other factors”. On p. 44 EI indicates that the inclusion of provider-specific fixed effects can be seen as an alternative to a stochastic frontier analysis to “allow for the possibility of some residual non-competitive effects in the deregulation data”.

In applying EI's econometric model, a decision has to be made about which provider (or combination of providers) to use as the benchmark provider. If the price data do indeed include some residual non-competitive effects, then it would make sense to select one of the lower price providers as the benchmark. This is the approach recently adopted by EI in developing a benchmarking model for the Australian Energy Regulator (AER) for electricity

distribution businesses in New South Wales. In that case, the fifth lowest cost business out of 13 Australian distribution businesses was chosen as the benchmark.¹ This benchmark was adopted by the AER.

In illustrating the use of its benchmarking model for the FAD, EI uses the median value of the provider effects (which, in this case, also corresponds to the largest provider). However, EI's Report (p. 53) states that "[W]e are not asserting that this value should necessarily be adopted." Nevertheless, the ACCC has adopted the median provider as the benchmark provider; that is, the fifth lowest (or fifth highest) price provider out of the nine providers in the dataset.

One of the arguments for not choosing one of the lower price providers as the benchmark is that some of these are small providers which might be considered to be outliers. However, this description does not apply to the third-lowest price provider, [REDACTED]. This provider operates [REDACTED] of the [REDACTED] deregulated services in the dataset ([REDACTED]), making it the third largest provider of deregulated services.

The coefficient for [REDACTED]'s effect in the ACCC's preferred model is [REDACTED], which is statistically significantly different from the median provider. This corresponds to a [REDACTED] discount on the prices of the median provider.

In my view, there are no strong grounds for choosing the median provider over [REDACTED] as the benchmark provider, and EI has not asserted that the median provider should be adopted. Adopting [REDACTED] as the benchmark would correct for possible "residual non-competitive effects" in the deregulated prices, and would be more in keeping with the approach adopted by the AER for electricity distribution (third lowest price provider out of nine DTCS providers compared to the fifth lowest cost business out of thirteen electricity businesses) than choosing the median provider as the benchmark.

Yours sincerely,



Robert Bartels

¹ Economic Insights (22 April 2015), *Response to Consultants' Reports on the Economic Benchmarking of DNSPs*, p. 66, and AER (April 2015), *FINAL DECISION: Ausgrid distribution determination 2015-16 to 2018-19, Overview*, p.41.