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Some key principles of incentive regulation

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When it comes to designing incentives for regulated firms, regulators tend to act in a largely heuristic manner. They recognise that the design of the regulatory mechanism (the regulatory ‘contract’ between the regulator and the regulated firm) affects the regulated firm’s incentives to pursue different objectives, but they are often unsure of the precise ‘power’ of the incentives that their regulatory contract creates; or how the power of the incentive to achieve one objective might affect the achievement of other objectives; or how the power of the incentive to achieve a given objective might change over time. Regulation therefore tends to be a process of trial and error, with adjustment and learning over time.

This article summarises some key principles that can help us understand the nature of the incentives that a regulatory regime creates and how we should go about designing those incentives to achieve the desired public policy objectives.

These principles come from the strand of economic literature known as ‘principal–agent’ or ‘agency’ theory. It has been known for many years that the relationship between a regulator and a regulated firm has many of the same characteristics as other contract relationships—such as the relationship between an employer and an employee or between a firm and its sub-contractors. However, some of the principles which have emerged from the principal–agent theory are not widely known and applied in the context of regulation. An understanding of these principles is helpful in designing effective regulatory regimes.

Review of principal–agent concepts

The key common element of models of principal–agent relationships is that the subordinate or ‘agent’ must take some kind of action towards the achievement of some objective which is desirable for the principal. But the principal cannot observe this action directly. Instead the principal can only observe a signal which is imperfectly correlated with the agent’s actions or effort. These models are therefore also known as ‘hidden action’ or ‘moral hazard’ models.¹

For example, the principal might be the landlord or owner of a farm and the agent, the tenant or sharecropper employed to work the farm. The principal would like to reward the agent directly for taking desirable actions (that is, working diligently and innovatively to increase the profit of the farm) but it cannot do so—it can only base the agent’s reward on an imperfect signal of the agent’s actions, such as the actual or out-turn profit of the farm. The problem is that the actual or out-turn profit of the farm depends on several factors—such as the weather or commodity market prices—which are completely outside the control of the share-cropper.

The fact that the principal cannot observe the agent’s actions directly leads to a trade-off between incentives and risk-sharing. The more the reward to the agent depends on the imperfect signal, the greater the agent’s incentive to take the desired action, but also the greater the risk to which the agent is exposed. In the sharecropping context the greater the sensitivity of the sharecropper’s income to the profit of the farm, the greater the incentive to increase that profit, but the greater the risk to which the sharecropper is exposed. Conversely, the lower the sensitivity of the sharecropper’s income to the out-turn profit of the firm, the more the sharecropper is ‘insured’ from the vagaries of the weather or the market, but the lower its incentive to pursue higher profit.

¹ The analysis here builds primarily on part IV of P. Milgrom and J. Roberts, *Economics, organisation and management*, Prentice-Hall, 1992.

There is another class of models, known as ‘hidden information’ or ‘adverse selection’ models that have also been widely applied to the study of the regulatory contract, as for example in the 1993 text by Laffont and Tirole (J.-J. Laffont, and J. Tirole, 1993, *A theory of incentives in procurement and regulation*, MIT Press). A key principle to emerge from those models is the need for the regulator to offer a menu of different incentive contracts. The regulated firm, in selecting a contract from the menu, reveals some information about its own characteristics. In those models the key trade-off is between incentives and rent-reduction—inefficient firms choose a low-powered incentive and earn no rent, while efficient firms choose a high-powered incentive and earn large rents.



The analogy with the relationship between a regulator and a regulated firm is reasonably clear. A regulator has several objectives which it would like the regulated firm to pursue. For example, the regulator might like the regulated firm to produce output of a high quality at a quantity sufficient to meet all demand to minimise the expenditure necessary to produce that output, and/or to find innovative ways to reduce expenditure and/or improve quality.

The regulator would like the firm to exert effort towards these objectives—such as the objective of minimising the expenditure necessary to produce a given output. The problem is that the regulator cannot directly observe the effort exerted by the regulated firm to reduce its expenditures—it can only observe the actual or out-turn expenditure of that firm. But the actual or out-turn expenditure partially depends on factors such as the weather, exchange rates, industrial action or changes in the level or nature of demand, which are not under the control of the regulated firm.

The regulator, in setting up the regulatory contract, must decide how much the profit of the regulated firm will depend on the out-turn or observed cost. If the regulated firm's profit is very sensitive to reductions in the out-turn or observed cost the regulated firm will have a strong incentive to reduce its cost, but will also be exposed to significant risk. If the regulated firm is largely insulated from variation in the out-turn or observed cost, the firm will have a very weak incentive to reduce its cost, but it will also be exposed to very little risk.

We may define the incentive's **power** on the regulated firm to pursue a particular objective as the sensitivity of the firm's profit with respect to effort towards that objective. For example, under a fixed-price contract the profit of the regulated firm is very sensitive to reductions in the expenditure of the firm, so the firm has a high-powered incentive to reduce its costs. Under a fixed price contract, for example, the regulated firm receives revenue which is completely independent of its costs. As a result the regulated firm's profit is very sensitive to changes in the realisation of its costs and therefore the firm has strong or high-powered incentives to reduce expenditure.

The linearity principle

The first principle I would like to highlight relates to the form of the optimal regulatory contract. It turns out that, under certain assumptions, the optimal regulatory contract is **linear** in the signal observed by the regulator.²

2 Specifically, the optimal regulatory contract is linear when the regulated firm exhibits constant absolute risk aversion and the 'error' in the signal observed by the regulator is normally distributed.

For example, let's suppose that the regulator cannot observe the effort exerted by the regulated firm towards reducing its costs but it can observe the actual cost out-turn. Let's denote the observed cost out-turn of the firm is \tilde{C} . Since the actual cost out-turn is unknown ex ante (it depends on factors such as weather or changes in wage rates which are uncertain and outside the control of the firm) the cost out-turn can be represented as a random variable. I will use the tilde symbol ($\tilde{\cdot}$) to denote random variables.

Let's assume that the regulator wishes to create incentives on the regulated firm to reduce its costs. As I have noted, under certain assumptions, the optimal regulatory contract is linear in the observed cost. That is, the optimal regulatory contract takes the form of $\pi(\tilde{C}) = A - B\tilde{C}$, where π is the allowed profit of the regulated firm, and A and B are constants.³

Let's assume that the effort of the regulated firm towards reducing its expenditure reduces the mean of \tilde{C} without changing its variance. In this case, without loss of generality we can assume that one unit of effort reduces the mean of \tilde{C} by \$1 (this is little more than a definition of what we mean by 'one unit of effort'). In this case the power of the incentive (which, we defined earlier to be the sensitivity of the firm's profit with respect to effort towards a given objective) is just equal to B .

For example, we could choose $B = 0$, so that $\pi(\tilde{C}) = A$. This is a very low-powered incentive—the firm is completely insulated from variations in its out-turn cost but has no incentive to reduce expenditure. Alternatively we could choose $B = 1$, so that $\pi(\tilde{C}) = A - \tilde{C}$. This regulatory contract yields strong incentives to reduce expenditure, but also exposes the regulated firm to significant risk. Laffont and Tirole (2000) write:

A high-powered incentive [to reduce expenditure] ... is one in which the firm bears a high fraction of its costs at the margin. That is, when the firm raises its cost by \$1, its net [profit] ... is reduced by an amount close to \$1 ... In a procurement context, a fixed-price contract, in which the contractor receives a fixed gross payment, is the prototypical high-powered incentive scheme, since the firm is made fully accountable for its cost savings. In contrast, a low-powered incentive scheme is one in which a \$1 increase in the firm's realised cost translates into about a \$1 [increase in the firm's allowed revenue] ... and so hardly affects the firm's profit. In particular, in a cost-plus contract, the firm's cost is reimbursed, and so the firm is not made accountable for its cost savings or overruns.⁴

3 In addition, if an increase in effort reduces the average value of the signal, the coefficient B is positive.

4 J.-J. Laffont and J. Tirole, 2000, *Competition in telecommunications*, MIT Press, p. 39.

But what is the optimal power of the incentive to reduce expenditure? Should we choose a 'high-powered' or a 'low-powered' incentive or something in between? Should we choose $B = 0$, $B = 1$ or set B equal to some other number between zero and one?

The incentive intensity principle

It turns out that in the simplest context in which there is a single objective and a single imperfect measure of the firm's effort towards that objective, the optimal power of the incentive to pursue that objective depends on:

- the precision with which the regulator can observe the action of the regulated firm—the higher the precision (i.e. the lower the 'variance' in the signal of the firm's effort) the higher the power of the optimal incentive
- the cost of effort (the higher the cost of effort exerted by the regulated firm the lower the power of the optimal incentive)
- the value to the regulator of additional effort directed towards the objective (in essence, how valuable is the pursuit of the objective to the regulator)
- the degree of risk-aversion of the regulated firm (the more risk-averse the regulated firm the lower the power of the optimal incentive).

I will focus on the first of these factors—the precision with which the regulator can observe the action of the regulated firm. Effectively what this means is that the greater the 'noise' in the signal observed by the regulator, the lower the optimal power of the incentive.

In the context of incentives to reduce expenditure, we saw above that the optimal contract is linear in the observed or out-turn expenditure. Now we can see that, in addition, the power of the incentive (the choice of B) depends on the link between the firm's effort to reduce cost and the out-turn expenditure. If there is only a very weak link between the firm's effort to reduce cost and the out-turn expenditure (for example, because the firm's out-turn cost depends on a large number of factors which are outside the control of the firm), the optimal power of the incentive is low. On the other hand, if there is a direct link between the firm's effort to reduce cost and the out-turn expenditure the optimal power of the incentive to reduce expenditure will be much higher.

We have observed that the greater the precision with which the regulator can observe the effort of the regulated firm, the greater the power of the optimal incentive. It is straightforward to show that the greater the precision with which the regulator



can observe the effort of the regulated firm, the higher the overall economic welfare.

An immediate implication is that it is economically valuable to increase the precision with which the regulator can observe the effort of the regulated firm. But how can the regulator go about improving the precision with which it observes the effort of the regulated firm? There are three primary ways:

- First the regulator can engage in more intensive monitoring and auditing of the regulated firm. The incentive intensity principle states that the greater the intensity of the monitoring and auditing of the regulated firm by the regulator, the greater the precision of the signal the regulator observes and the greater the power of the optimal incentive. In fact, intensive monitoring by the regulator and high-powered incentives are **complementary** activities—each tends to increase the value of the other.
- If there are comparable firms which are subject to similar cost-shifting factors, the precision with which the regulator observes the effort of the regulated firm could be improved by taking into account the expenditure out-turns of the other comparable firms. This is commonly known as ‘benchmarking’ or ‘yardstick regulation’.
- Similarly, if the regulated firm is subject to similar cost-shifting factors over time, the precision with which the regulator observes the effort of the regulated firm could be improved by taking into account past expenditure out-turns of the regulated firm.

We will explore these last two cases in more detail in the discussion below.

The ‘informativeness’ principle

We saw above that if the regulator could observe a signal of the action taken by the regulated firm, it is efficient for the regulatory contract to depend on this signal and the optimal regulatory contract is linear in that signal.

But what if the regulator can observe two or more signals of the action taken by the regulated firm? Should we include both signals in the regulatory contract?

For example, it might be the case that, in addition to observing the cost out-turn of the regulated firm, the regulator might be able to observe other signals which might shed light on the effort exerted by the regulated firm to keep its expenditure down. These other signals might include economy-wide factors such as changes in wage rates, or the cost out-turns of other firms in comparable markets, or

the cost out-turn of the same firm in the past. If the regulator observes that the expenditure of the firm has increased significantly compared to the past this might be a signal that the firm is not exerting as much effort to keep expenditure down.

Let’s suppose that the regulator can observe another signal of the effort of the firm to reduce its expenditure which we will denote \tilde{Y} . When and how should the regulator make use of this signal in designing its regulatory contract?

It turns out that the regulator should make use of this new signal \tilde{Y} if and only if making use of this signal improves the precision with which the regulator can observe the (hidden) effort of the regulated firm.

This principle is known as the ‘informativeness’ principle. It states that when designing a regulatory contract the regulator should always factor into the regulatory contract any signal that improves the precision with which the regulator can observe the effort of the regulated firm (and, conversely, should exclude from the regulatory contract any signal which reduces the precision with which the regulator can measure the effort of the regulated firm).

By the linearity principle, the new regulatory contract is linear in both the signals \tilde{C} and \tilde{Y} , so we can write the regulatory contract $\pi(\tilde{C}, \tilde{Y}) = A - B(\tilde{C} - D\tilde{Y})$. The optimal regulatory contract is now the choice of D which minimises the variance of $\tilde{C} - D\tilde{Y}$. Simple calculus shows that the value of D which minimises the variance of $C - D\tilde{Y}$ is: $D = \frac{\text{cov}(\tilde{C}, \tilde{Y})}{\text{var}(\tilde{Y})}$.

The ‘informativeness’ principle has a number of interesting implications. To begin with, we can observe that the regulatory contract $\pi(\tilde{C}, \tilde{Y}) = A - B(\tilde{C} - D\tilde{Y})$ can be written as $\pi(\tilde{C}, \tilde{Y}) = A - B(\tilde{C} - D\tilde{Y}) = A - B\tilde{C} + BD\tilde{Y}$. From this expression it is clear that as long as $D > 0$, the regulated firm’s profit is increasing in the signal \tilde{Y} . Let’s suppose that for some reason the regulated firm can take actions which might alter the value of \tilde{Y} . Anticipating the discussion a little later in this article, we have now created an incentive mechanism which creates two sets of incentives on the regulated firm—an incentive to reduce expenditure \tilde{C} and an incentive to increase the size of the signal \tilde{Y} .

Recall that the power of an incentive to pursue a given objective is equal to the sensitivity of the profit of the regulated firm to a change in effort devoted towards that objective. In this case, since the coefficient of \tilde{Y} (which is equal to BD) in the

regulatory contract is positive, the regulated firm has an incentive to exert effort to **increase** the signal. The power of the incentive to increase the signal \tilde{Y} is higher the greater the power of the incentive to reduce expenditure (i.e. the greater is B) and the greater the reliance on the signal \tilde{Y} (i.e. the greater is D).

In practice, signals that shed light on the likely cost out-turn of the regulated firm are usually taken into account in the process of defining the ‘target’ or ‘forecast’ level of expenditure of the regulated firm. The discussion above highlights that regulated firms will commonly have an incentive to exert effort to **raise** the value of the target expenditure. We might call this the ‘target’ principle. For example, it is common to observe regulated firms exerting a great deal of effort in the regulatory submission process to convince the regulator that in the future likely expenditure requirements are going to be higher than out-turn expenditure in recent years. This incentive doesn’t just stop at lobbying. Regulated firms will have an incentive to take any of a range of actions which will increase their target expenditure in future.

A second interesting implication of the ‘informativeness’ principle relates to the usefulness of ‘relative performance evaluation’, ‘benchmarking’ or ‘yardstick competition’. Suppose that the regulator is attempting to create incentives on firm 1 to reduce its cost and can observe cost out-turn of firm 1, which we will denote \tilde{C}_1 . Suppose that there is another firm which is exposed to many of the same cost ‘shocks’ as firm 1, with an observed cost out-turn \tilde{C}_2 . The ‘informativeness’ principle says that, because observing the cost out-turn \tilde{C}_2 allows the regulator to increase the precision with which it observes the effort of firm 1, the optimal regulatory contract for firm 1 should also depend on the cost out-turn for firm 2, \tilde{C}_2 .

But how exactly should the optimal regulatory contract for firm 1 depend on the cost out-turn for firm 2? From the discussion above we know that the optimal regulatory contract takes the form: $\pi(\tilde{C}_1, \tilde{C}_2) = A - B(\tilde{C}_1 - D\tilde{C}_2)$, where $D = \frac{\text{cov}(\tilde{C}_1, \tilde{C}_2)}{\text{var}(\tilde{C}_2)}$.

We can write this as $\pi(\tilde{C}_1, \tilde{C}_2) = A - B((1 - D)\tilde{C}_1 + D(\tilde{C}_1 - \tilde{C}_2))$.

Written in this way it is clear that the optimal regulatory contract should include elements of both **relative** and **absolute** performance evaluation. In other words, under the optimal regulatory contract the regulated firm should be both rewarded for reducing its own costs and also further rewarded for the difference between its own costs and that of a comparable firm.⁵



This observation is directly relevant to regulatory policy. There are often debates in regulatory circles of the relative merit of regulatory mechanisms based primarily on ‘own costs’ and regulatory mechanisms based primarily on ‘benchmarking’ or ‘relative performance’. From this discussion we can see that this is not an either/or choice. In fact the optimal regulatory contract will, in general, include a component of **both** relative and absolute performance evaluation.

The weighting of relative and absolute performance evaluation depends on how much information the regulator obtains by observing the cost out-turn of another firm. If the difference in the costs of the two firms is virtually entirely driven by differences in their effort, the optimal regulatory contract should depend almost entirely on the relative performance of the two firms (i.e. D should be close to one). On the other hand, if the second firm’s cost out-turn is primarily affected by factors which do not affect the first firm, the weight on relative performance evaluation will be small (i.e. D should be close to zero)—instead, the regulatory contract will depend primarily on each firm’s own cost out-turn.

The ratchet effect

There is one more implication of the ‘informativeness’ principle which is worth emphasising as a principle in its own right. Let’s suppose the regulator determines that the factors which affect the expenditure of the firm in any one period will persist, to an extent, from one period to the next so that information about past expenditure out-turns provides some information about likely expenditure out-turns in the future. In this case the regulator might decide that the precision with which it is able to observe the effort of the regulated firm could be improved if it were to take into account past expenditure out-turns when setting the regulatory contract. But what effect does this have on the incentives of the regulated firm?

Let’s suppose that the regulator decides to adopt a regulatory contract which, each period, depends on the cost out-turn in both the present period \tilde{C}_t and one period earlier \tilde{C}_{t-1} . If we allow δ to be the discount rate, we can write the regulatory contract as follows:

$$\pi_t(\tilde{C}_t, \dots) = A_t - B_t(\tilde{C}_t - D_t\tilde{C}_{t-1}) + \delta[A_{t+1} - B_{t+1}(\tilde{C}_{t+1} - D_{t+1}\tilde{C}_t)] + \delta^2[\dots]$$

Focusing on just the part of the regulatory contract that depends on the cost out-turn \tilde{C}_t , we see that the regulatory contract above can be written as:

$$\begin{aligned} \pi_t(\tilde{C}_t, \dots) &= A_t - B_t\tilde{C}_t + \delta B_{t+1} D_{t+1} \tilde{C}_t + \dots \\ &= A_t - (B_t - \delta B_{t+1} D_{t+1})\tilde{C}_t + \dots \end{aligned}$$

Recall that the power of the incentive to reduce expenditure is given by the sensitivity of the profit with respect to changes in the out-turn expenditure. From the above expression we can see that power of the incentive to reduce expenditure is no longer B_t but is, instead, $B_t - \delta B_{t+1} D_{t+1}$.

In other words, (where $D_{t+1} > 0$) the effect of taking into account past expenditure out-turns in the regulatory contract is to **lower** the power of the incentive to reduce expenditure. Intuitively, the reason is that effort to reduce expenditure in the present period is rewarded in the present period but also increases the size of the ‘target’ expenditure in subsequent periods.

The tendency for performance standards to increase after a period of good performance is called the ratchet effect. The term was originally coined by students of the Soviet economic system, who observed that managers of Soviet enterprises were commonly ‘punished’ for good performance by having higher standards set in the next year’s plan ... There are widely known instances of Soviet factory managers who responded to newly installed incentives with massive gains in productivity, only to be denounced on the grounds that their improved performance was proof that they had previously been lazy or corrupt.⁶

A firm which anticipates that current performance will be used to set future performance targets will have a reduced incentive to improve its performance today. As the above expression shows, the amount by which the incentive is reduced depends on (a) the discount rate δ ; and (b) the power of the incentive to increase the target in the future (which, in this case, is equal to $B_{t+1} D_{t+1}$).

Consider a high-powered incentive [to reduce costs] ... It is clear that even though the firm is formally residual claimant for its cost savings, an effort to reduce cost by \$1 is not rewarded by a \$1 [increase in profit] overall. A lower cost will convince the regulatory authority of a higher efficiency and will make it more demanding ... for the firm at the next regulatory review. So while a \$1 cost reduction yields \$1 to the firm in the short-run, it also entails a long-term penalty in the firm of higher performance requirements at the next review. This is the well-known *ratchet effect*. The ratchet effect imposes a bound on the

incentives that can be provided even by formally high-powered incentives.⁷

One immediate corollary is that the regulator can reduce the significance of the ratchet effect—and increase the power of the incentive to reduce expenditure—by increasing the length of the regulatory period (which reduces the discount rate δ). This is, of course, the primary argument in favour of the five-year regulatory period—a longer regulatory period is a form of commitment by the regulator to not take into account recent cost information on a regular basis.

Of course, one problem with the five-year regulatory period is that the power of the incentive to reduce expenditure is likely to vary over the course of the regulatory period depending on how the regulator takes past cost out-turn information into account when setting future regulatory targets. I will leave this issue for a future discussion.

It is also worth emphasising that the ratchet effect does not always necessarily weaken incentives. In fact, it could be the case that a reduction in the expenditure out-turn today (i.e. a reduction in \tilde{C}_t) is associated with a higher expected expenditure tomorrow (i.e. an increase in \tilde{C}_{t+1}). This would be the case, for example, if a reduction in expenditure in one period was primarily interpreted as a deferral of necessary expenditure into future periods. In this case, the covariance between \tilde{C}_t and \tilde{C}_{t+1} is negative, so the coefficient D_{t+1} is negative. In this case the impact of the ratchet effect is to increase the power of the incentive to reduce expenditure today ($B_t - \delta B_{t+1} D_{t+1}$ is larger than B_t) because a reduction in expenditure today is ‘rewarded’ with a higher target tomorrow. Of course, it is not usually desirable to enhance the incentive to reduce expenditure by merely deferring economically valuable projects.

The equal compensation or ‘balance’ principle

There is one final principle which is worthwhile understanding in detail. Very often there are many objectives which the regulator would like the regulated firm to pursue. For example, as mentioned earlier, a regulator may wish the regulated firm to simultaneously reduce its expenditure while maintaining or improving the quality of its services. Alternatively, the regulator may wish the regulated firm to exert similar levels of effort in minimising different categories of expenditure—such as operating expenditure and capital expenditure.

If the regulator has two or more objectives it would like the regulated firm to pursue, how does this affect the analysis described above?

5 In the case where there are a number of comparable firms all of whose costs are equal to the cost of firm 1 plus a random error term, the optimal regulatory contract for firm 1 depends in part on the relative performance of firm 1 relative to the average cost out-turn for the other firms.

6 P. Milgrom and J. Roberts, *Economics, organisation and management*, Prentice-Hall, 1992, p. 233.

7 J.-J. Laffont and J. Tirole (2000), p. 55.



It turns out that there is an important interaction between the power of the incentive to pursue one objective and the effort exerted by the regulated firm towards another objective. If one objective is rewarded with a high-power incentive and another objective is rewarded with a low-powered incentive, the regulated firm is very likely to reduce its effort on the low-powered incentive to enable it to increase its effort on the high-powered incentive.

In fact, if the marginal cost of effort depends only on the total quantity of effort expended, the firm will choose to direct **all** of its effort towards the objective with the highest power and will neglect all the other objectives entirely. This might be the case if, for example, effort is related to the amount of time the manager spends on pursuing a particular objective. If the total cost to the manager depends only on the total time spent pursuing all the objectives, the optimal policy for the manager is to devote all of his/her time to the objective which has the highest power.

There are numerous examples of high-powered incentives on one objective distorting the allocation of effort to other objectives. Prendergast cites the example of the contract offered to an American football quarterback Ken O'Brien in the mid-1980s:

Early in his career, he had a tendency to throw interceptions. As a result he received a contract that penalised him every time he threw the ball to a member of the opposition. However while it was the case that he subsequently threw fewer interceptions, this was largely because he refused to throw the ball, even in cases where he should have done so. As Joe Namath put it: 'I see him hold onto the ball more than he should ... I don't like incentive contracts that pertain to numbers'.⁸

In the regulatory context, if a regulated firm faces a high-powered incentive to reduce cost, but little or no incentive to maintain quality, the management of the firm has an incentive to direct all of its efforts towards reducing cost at the expense of reducing the quality of the services they provide.

How does the observation that the regulated firm will allocate all of its effort to the objective with the highest power affect the design of the regulatory contract? In this context, if the regulator wishes the regulated firm to expend effort on more than one objective, the power of the incentive to pursue all objectives must be the same. This has been called the 'equal compensation' principle. More generally, the regulator must pay attention to ensuring the 'balance' between the power of the incentive to pursue different objectives.

One immediate consequence of the balance principle is that, in the case where the principal

is not able to observe the agent's effort towards one particular objective at all (even imperfectly), the principal cannot use high-powered incentives on any objective. Milgrom and Roberts emphasise this result as follows (paraphrasing the original):

The equal compensation principle imposes a serious constraint on the incentive regulation mechanisms that can be effective in practice. In particular, if a regulated firm is expected to devote some effort in the pursuit of an objective for which performance cannot be measured at all, then incentive regulation cannot be effectively used for **any** of the objectives that the regulator might wish to pursue. The use of straightforward rate-of-return regulation can often be justified on these grounds.⁹

The balance principle has many applications in the field of regulation. Let's suppose, for example, that it is difficult for the regulator to measure the effort directed by the firm towards improving or maintaining its quality of service. This might be because, for example, the observed quality of service is heavily dependent on weather or demand outcomes which are outside the control of the regulated firm (e.g. storms or bushfires might cause supply interruptions even on a well-maintained network). In this case the regulator cannot impose high-powered incentives on quality—as doing so would impose unacceptable risk on the regulated firm. As a result, the balance principle states that the regulator **must** use low-powered incentives for all other objectives—including the objective of cost minimisation—otherwise, the regulated firm will have an incentive to lower quality to reduce expenditure.

The problems created by trying to impose high-powered incentives to reduce expenditure in a context in which quality is difficult to measure are well-known:

Indeed, the U.S. Department of Defence has often invoked it to motivate the use of cost-plus contracts in contexts in which quality is a sensitive issue and its specifications are hard to pin down exactly ... Similarly, the argument has been made several times that the introduction of incentive regulation for power companies conflicts with the safe operation of nuclear power plants. As a last illustration, quality started deteriorating shortly after British Telecom's 1984 privatisation and design of more powerful incentives in the form of a price cap, and quality standards and verification mechanisms had to be set up as a consequence.¹⁰

High-powered incentives not only create problems in distorting the allocation of effort between cost minimisation and maintaining quality—they may

also distort the incentives to minimise different categories of cost.

For example, it may be that the regulator has a better signal of the firm's effort at reducing operating expenditure than capital expenditure. Operating expenditure tends to be recurrent, so that past cost out-turns provide more information about likely future levels of operating expenditure. In contrast, although there are elements of capital expenditure which are recurrent, in many regulated industries a large proportion of capital expenditure consists of expenditure on 'one-off' projects which provide little or no useful information about the likely level of future capital expenditure requirements in the future.

If we consider the objectives to reduce capital expenditure and operating expenditure separately, given the greater difficulty in measuring the effort to reduce capital expenditure, it would seem sensible to adopt a lower powered incentive for capital expenditure than for operating expenditure. But this is likely to induce inefficient substitution between capital expenditure and operating expenditure:

Suppose that a firm keeps 75 cents per dollar of cost reduction on activity 1 [opex, say] and only 25 cents per dollar of cost reduction on activity 2 [capex, say]. Then saving \$1 on activity 1 and increasing the cost of activity 2 by \$1 yields a net benefit of 50 cents for the firm.

This cost transfer may occur in two ways. The first ... involves *accounting cross-subsidies*. The firm benefits from allocating costs that are incurred in the provision of activity 1 to activity 2. This may involve reporting that personnel or other variable inputs that were used in activity 1 were dedicated to activity 2 or (and harder to detect) the firm may allocate a large share of jointly incurred costs to activity 2. In an attempt to prevent accounting cross-subsidies, regulators routinely impose 'accounting separation' between activities, together with rigid (and arbitrary) rules for allocating the joint costs that are incurred in the simultaneous provision of these activities.

Careful accounting procedures, however, cannot prevent ... transfers associated with managerial decisions ... For example, the firm may allocate its inexperienced or underperforming personnel to the activity with the lower-powered incentive (activity 2) and the trained and best-performing employees to activity 1.¹¹

According to the balance principle, the power of the incentive to reduce opex should be the same as the power of the incentive to reduce capex—otherwise the regulated firm will be induced to inefficiently

8 Prendergast, Canice, 1999, 'The Provision of Incentives in Firms', *Journal of Economic Literature*, March 1999, p. 9.

9 Milgrom and Roberts (1992), p. 9.

10 J.-J. Laffont and J. Tirole (2000), p. 54.

11 J.-J. Laffont and J. Tirole (2000), p. 53.

substitute from opex to capex. This balance can be achieved by basing the incentive on the total expenditure (i.e. the sum of the operating expenditure and capital expenditure).

In effect, there must be a balance between all of the different incentives which the regulator seeks to create. A high-powered incentive towards any one objective must be balanced with similar incentives to promote (or at least maintain) other objectives—otherwise the regulated firm will pursue the high-powered incentive and will neglect the other objectives. The ACCC has recognised this

need for balance in its statement of regulatory principles.¹²

Conclusion

I have described five key principles which shed light on the optimal design of incentives in regulatory contracts. These principles are (a) the linearity principle (b) the incentive intensity principle (c) the

¹² See the diagram on p. 20 of ACCC, 'Decision: Statement of principles for the regulation of electricity transmission revenues—background paper', 8 December 2004.

'informativeness' principle (d) the ratchet effect and (e) the balance principle. I have described these principles at a relatively broad level. There remains a sizeable task of implementing principles such as these in the context of a specific regulated industry or regulated firm. In particular, there is the interesting question of how these principles should be made concrete in the context of the building block model. This is a topic which must be left for another occasion.



national developments

Telecommunications

ACCC issues Telstra accounting separation report for December quarter 2004

The ACCC issued its December 2004 quarter imputation testing and non-price terms and conditions report under the enhanced accounting separation regime for Telstra on 31 March 2005.

The first part of the report presents an imputation analysis that compares Telstra's retail prices with the prices of three core telecommunications access services: local carriage service, the public switched telephone network (PSTN) originating and terminating access service and the unconditioned local loop service (ULLS).

The results for fixed line voice services show that there were sufficient margins for domestic and international long-distance calls and fixed-mobile calls, but not for local call services (line rental and local calls combined).

The report also contains imputation testing of the ULLS. The report indicates that the average margins available in the provision of ADSL or of a bundle of ADSL and voice services over the ULLS are not sufficient to recover costs. The ACCC notes that the cost of transforming the ULLS into the retail services, rather than the cost of the ULLS itself, appears to be the main cause of the insufficient margins.

The second part of the report presents key performance indicators that compare Telstra's customer service performance in meeting certain non-price terms and conditions for its wholesale and retail customers.

The report does not reveal any systematic discrimination against Telstra's wholesale customers. However, the ACCC is concerned that outages in Telstra's fault-handling and provisioning systems have led to delays in service to wholesale customers, and intends to monitor the reliability of these systems to better ensure that they do not become a source of discrimination.

ACCC issues fourth Telstra accounting separation current cost report

The ACCC issued the fourth current cost accounting separation report relating to Telstra on 29 April 2005.

The report is intended to provide greater transparency of Telstra's operations to ensure that it does not unfairly discriminate between access seekers using its network services and its own retail operations.

The report provides present day valuations of Telstra's assets that are compared with the historical or original cost of these assets. The report also includes profit and loss and capital employed statements prepared on a current cost basis.

The report indicates that on a current costs basis, the aggregate values of assets for the core access services are substantially higher than the historical asset valuations. In proportionate terms, this is particularly apparent for the unconditioned local loop and local carriage services. The information does not, however, represent the forward looking cost of assets nor is it calculated using a fully or substantially optimised network configuration.

ACCC issues annual assessment of telecommunications competition

The ACCC issued two annual reports on issues relating to competition in the telecommunications industry in 2003–04 on 31 May 2005. The ACCC is required to provide two annual telecommunications reports to the Minister for Communications, Information Technology and the Arts, under Division 11 and 12 of Part XIB of the *Trade Practices Act 1974*:

- the competitive safeguards report under subsection 151CL(1) of the Act
- the changes in the prices paid by consumers for telecommunications services report under paragraph 151CM(1)(a) of the Act.

The competitive safeguards report revealed that competition in the telecommunications sector had provided positive outcomes over the past seven years, but that the positive effects slowed in 2003–04, continuing a trend observed for 2002–03.

The report asserts that further market advances, in terms of higher quality and more keenly priced services, will only be likely if there is an increase in competition further up the value chain in facilities or quasi-facilities-based markets.

The report notes that encouraging the move towards facilities-based competition is dependent on overcoming the difficulties posed by Telstra's dominance in the customer access network and the fixed-line market. To this end, the ACCC will be placing considerable emphasis on ensuring that competitors are not frustrated in obtaining timely access to Telstra's underlying, regulated facilities.

The report on prices paid for telecommunications services shows that, overall, average prices paid by



telecommunications consumers decreased by 1.1 per cent during 2003–04.

This overall decline reflects the combination of a marginal increase of 0.2 per cent in prices paid for PSTN services and a decrease of 3.2 per cent in prices paid for mobile services.

The average prices paid by residential and small business customers rose by 1.4 per cent and 3.1 per cent respectively. On the other hand, the average price paid by large business consumers fell by 5.6 per cent.

In terms of individual PSTN (public switched telephone network) services, the trend of increasing basic access prices and falling per-call prices observed in previous years largely continued, with the average price paid for basic PSTN access rising by 6.8 per cent.

For mobile services, the 3.2 per cent decrease in the overall price paid was primarily due to lower prices paid by consumers for pre-paid services.

ACCC issues report on Telstra's compliance with its price controls

The ACCC issued its annual assessment of Telstra's compliance with the price control arrangements on 17 March 2005.

The government determines the price control arrangements and the ACCC's role is to assess the adequacy of Telstra's compliance with them. Under the arrangements, the ACCC is responsible for developing a methodology by which to measure price changes, assessing the accuracy and completeness of Telstra's report and providing an annual report to the Minister on Telstra's compliance.

The ACCC was satisfied that Telstra has adequately complied with its price control arrangements. The ACCC, however, noted that changes in Telstra's pricing of services to pensioner customers has permitted further increases in line rental prices. The ACCC considers that this practice by Telstra is inconsistent with the structure and objectives of the price control arrangements.

Vodafone mobile terminating access service undertaking discussion paper

A discussion paper on a second access undertaking lodged by Vodafone in relation to the mobile terminating access service (MTAS) was issued by the ACCC on 14 April 2005.

The undertaking specifies some of the price and non-price terms and conditions on which it proposes to supply the MTAS on its second

generation (2G) and 2.5G mobile networks.

The undertaking, lodged on 23 March 2005, replaces a previous undertaking lodged by Vodafone in relation to the MTAS on 26 November 2004.

Vodafone withdrew its previous undertaking on 12 April 2005 following the discovery of errors in the cost model which supported its previous undertaking. The discussion paper invites submissions on any aspect of the undertaking.

The ACCC is also currently arbitrating eight access disputes in relation to the MTAS under the dispute resolution procedures in Division 8, Part XIC of the Act.

ACCC issues record keeping rules for internet interconnection

The ACCC issued a record keeping rule (RKR) and a disclosure direction to 20 leading internet service providers (ISPs) as part of a three year monitoring regime of the internet industry on 29 March 2005.

The monitoring program is aimed at identifying how interconnection of internet networks works in practice, and what effects that has on the markets that rely on interconnection.

Internet interconnection allows customers—business, residential or others—that are connected to one internet network, to send and receive emails, access websites and exchange information with users connected to other internet networks. Internet interconnection also enables business and other consumers to make the content they store on the internet accessible to other users.

The ACCC's RKR follows its final report on whether to declare an internet interconnection service, which found that a case has not been made for regulation at this stage, but that there are sufficient concerns to warrant the implementation of a rigorous but carefully targeted monitoring program.

The details of the monitoring regime have been developed after taking into account industry concerns about the burden of compliance with such a program. The RKR is intended to give the ACCC a greater understanding of the industry's competitive dynamics.

The ACCC will review the operation of the monitoring program after it has received data for the first 12 months.

ACCC issues third telecommunications market indicator and infrastructure reports

The ACCC issued its third report on telecommunications market indicators and its third report on telecommunications infrastructure on 15 June 2005.

The market indicators report contains selected revenue, usage and market share data concerning fixed-line voice and mobile telecommunications services for 2003–04 for the five largest service providers. The market indicators report has been compiled from information provided under the Regulatory Accounting Framework.

The market indicators report notes that fixed-line voice markets continued to grow in 2003–04, with total market revenue increasing by 3.5 per cent to \$9.4 billion. In 2002–03 the market had grown by 1.3 per cent. This has largely been driven by increases in total revenues for line rental and fixed-to-mobile calls, which grew by 11.5 per cent and 5.8 per cent respectively in 2003–04. These growing services have offset decreases in revenues for local, domestic long-distance and international calls. The market for mobile services grew faster than the market for fixed-line services during 2003–04, with total mobiles market revenue increasing by 6.3 per cent to around \$6.9 billion.

The reported market share data for the period covered by the report, 2001–02 to 2003–04, has on the whole remained stable, with Telstra remaining the dominant carrier in the fixed line voice market. Telstra earned 75 per cent of total fixed line voice revenues in 2003–04, compared to 79 per cent in 2001–02. Its market share was higher in basic line rental (where it had 82 per cent of the market).

In the mobile services market, in 2003–04 Telstra earned 48 per cent of revenue, compared to 35 per cent for Optus and 15 per cent for Vodafone. In comparison, those carriers had 52 per cent, 25 per cent and 19 per cent of the market respectively in 2001–02.

The telecommunications infrastructure report also relates to the 2003–04 financial year and is compiled largely from survey data that has been supplied by carriers.

During 2003–04, more than \$2.5 billion was invested in telecommunications infrastructure. Investment in mobile network infrastructure accounted for almost half of this amount (44 per cent), followed by local access networks (35 per cent), transmission networks (14 per cent), xDSL services (6 per cent) and ISDN services (2 per cent).

Carrier investment plans indicate the likelihood of increasing investment in 2004–05, in particular, in xDSL infrastructure.



ACCC issues discussion paper on future local services regulation

The ACCC issued a discussion paper on the future of local services regulation on 22 April 2005, marking the start of a full review of local call regulation in Australia.

Primarily the review is a reconsideration of the local carriage service (LCS) declaration and pricing. The LCS is a declared wholesale service for end-to-end local calls.

The ACCC is obliged to review the declaration before June 2006, however ongoing concerns about the competitive impact of local call pricing led the ACCC to bring the review forward by several months. Specifically, there are continuing concerns about the impact of aggressive bundling of other voice services and broadband on the local call market and the increasing inability of other service providers to compete when selling local calls. In addition the ACCC considers that there are questions about whether the local call declaration is still needed to act as a catalyst for facilities-based competition or whether there are now feasible alternatives for fulfilling that objective.

In considering these issues, the inquiry will also look at the desirability of declaring a wholesale line rental service.

The ACCC expected submissions from interested parties in early June 2005.

ACCC issues final advice on future Telstra price controls

The ACCC report on the price control arrangements that should apply to Telstra after 1 July 2005 was publicly issued by the Minister for Communications, Information Technology and the Arts, Senator Helen Coonan, on 30 March 2005.

The ACCC's recommendation is that price cap regulation should continue on the services to which it currently applies. However, the ACCC considers that services to businesses with more than five lines should no longer be subject to price controls.

In particular, the ACCC recommends that:

- a basket containing line rental, local calls, domestic and international long-distance calls and fixed-to-mobile calls should decrease in price by 4 per cent per year in real terms, that is, be subject to a price cap of CPI - 4 per cent
- the price of connection services should not increase by more than the CPI.

In relation to line rental prices, the ACCC recommends a price control over Telstra's most basic local access products, currently branded HomeLine

Part and BusinessLine Part. The ACCC recommends that the price of line rental in these products should not increase by more than the CPI. The ACCC also recommends that it assess proposed line rental increases before implementation to ensure Telstra complies with the price controls.

In addition, the ACCC recommends that:

- the current cap of 22 cents on the price of a local call should remain
- the current cap of 40 cents on the price of a local call from payphones should remain
- dial-up internet calls to ISPs should be subject to the 22 cent local call cap
- ministerial consideration of directory assistance charges should remain but not be extended to other ancillary charges
- while the current non-metropolitan local call relativity provisions should be retained, direct government assistance should be considered as a better way to improve access for regional and rural consumers
- the current provisions relating to extended zones should be retained.

The ACCC considers that, while the current low-income scheme has delivered some important benefits to low-income consumers, there are changes that could improve the scope and robustness of the scheme.

The ACCC's recommendation is that the next price control arrangements should apply for three years.

ACCC proposes reducing regulation of DDAS and ISDN services

The ACCC issued its draft decision proposing the removal of regulation of certain aspects of the existing digital data access (DDAS) and ISDN service declarations on 18 April 2005.

The ISDN is used for the carriage of information such as voice, data, high quality sound, text, still images and video over the PSTN. The service was declared in 1998. The DDAS is an access service for the domestic carriage of data. The service can combine the use of a customer access line with management to ensure high quality data transmission. The service was declared in 1997.

The draft decision is for DDAS and ISDN services in CBD and metropolitan areas of capital cities to be removed from declaration by 30 June 2006 or 12 months from the current expiry date for these services. This will provide a sufficient period for existing access seekers to migrate to alternative services in capital cities.

In relation to regional areas, however, the lack of competition for the provision of data services means that the existing declarations should remain in force for the foreseeable future—the ACCC is proposing to review the regional declarations in three years time.

The ACCC expects to issue a final report in June 2005.

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Gas

Access arrangements

Central Ranges pipeline

On 25 May 2005 the ACCC granted a request by Central Ranges Pipeline Pty Ltd that the lodgment date for the proposed access arrangement be extended from 30 May 2005 to 5 August 2005. The ACCC has previously granted three requests for extensions of time for the lodgment of the access arrangement. Section 7.19 of the National Third Party Access Code for Natural Gas Pipeline Systems (the gas code) does not limit the length or number of times that extensions can be granted to parties.

The pipeline became a covered pipeline under the gas code following approval by the ACCC in May 2004 of a competitive tender process conducted by the Central Ranges Natural Gas & Telecommunications Association Inc.

Access arrangement revisions

Moomba to Adelaide pipeline system

On 27 April 2005 the ACCC granted a request by Epic Energy South Australia Pty Ltd that the lodgment date for its revised access arrangement be extended from 1 July 2005 to 1 October 2005 pursuant to s. 7.19 of the gas code.

Epic Energy applied to the National Competition Council (NCC) on 15 March 2005 for revocation of coverage of the Moomba to Adelaide pipeline system (MAPS). It submitted to the ACCC that an extension of time could help limit the resources spent on the revisions as it would not need to prepare and lodge the revision if its revocation application were to be successful, and undertook to commence the work required to prepare the revision to the access arrangement if the NCC makes a final recommendation to the minister not to revoke coverage.

On 27 April 2005, the ACCC decided, pursuant to s. 7.19 of the gas code, to grant the requested



extension until 1 October 2005. The existing terms of the access arrangement will continue in the event that the revisions approval process is not completed by January 2006.

Access arrangements—annual tariff variations

Moomba to Sydney pipeline

The ACCC approved variations to the reference tariffs for the Moomba to Sydney pipeline (MSP) on 8 June 2005. The ACCC determined that East Australian Pipeline Limited correctly applied the CPI-X tariff escalation formula specified in section 8.15 of its access arrangement. The tariff increase takes effect from 1 July 2005.

Central West pipeline

The ACCC approved a variation to the reference tariff for the Central West pipeline (CWP) on 1 June 2005. The ACCC determined that APT Pipelines (NSW) Pty Ltd correctly applied the CPI-X tariff escalation formula specified in section 3.1 of its access arrangement. The tariff increase takes effect from 1 July 2005.

Australian Competition Tribunal determinations

Moomba to Sydney pipeline system—tribunal sets asset base

On 18 March 2005 the Australian Competition Tribunal handed down its decision on the regulatory asset base of the Moomba to Sydney transmission pipeline system.

In July 2004 the tribunal rejected both the amount determined by the ACCC for the pipeline assets of \$545 million and the \$764 million proposed by the pipeline owner Eastern Australian Pipeline Limited (EAPL). Instead, the tribunal was of the view that the regulatory asset base should be set equal to its depreciated optimised replacement cost (DORC) value.

This required considering various approaches to depreciation. In doing so, the tribunal further rejected the alternative methodologies proposed by the ACCC and EAPL. Instead, it stated that the appropriate methodology required an assessment of the difference between the present value of the future costs of operating the existing pipeline and operating an optimised alternative pipeline.

The tribunal has now determined a regulatory asset base for the MSP of \$834.66 million using this methodology. The tariff to be applied to regulated gas haulage services provided by the MSP has been set following further submissions to the tribunal.

The tribunal's earlier decision on the asset base methodology is already the subject of an application by the ACCC for review by the Federal Court. It is expected that the Federal Court will hear the matter in August 2005.

Authorisations

Application for authorisation of joint marketing by PNG gas producers

On 14 December 2004 the joint venture participants in the PNG Gas Project applied to the ACCC for authorisation to negotiate the common terms and conditions (including price) under which gas produced by the project will be offered for sale (joint marketing).

The PNG Gas Project involves the development of petroleum fields in the Southern Highlands of PNG and the marketing of natural gas produced from those fields to Australian customers. The gas will be transported to customers via a pipeline from PNG to Queensland.

In addition to seeking authorisation to jointly market their gas, the applicants have proposed that the authorisation apply for the life of the project (estimated at 30 years) and also cover future participants in the project.

On 23 December 2004 the ACCC released an issues paper calling for submissions from interested parties. Submissions were due by 15 February 2005 and the ACCC has received eight submissions. The ACCC is currently preparing its draft determination.

Submissions—Victoria inquiry into cross-ownership rules for the energy sector

In February 2005 the Victorian Department of Infrastructure released an issues paper relating to current cross-ownership rules which apply in the Victorian energy sector. In response to that issues paper, the ACCC made a submission to the inquiry in April.

In its submission, the ACCC outlined its views that an electricity industry specific policy would complement the role of the *Trade Practices Act 1974* in protecting competitive processes. The submission outlined a strong case for National Electricity Market wide provisions dealing with generation—transmission and generation—generation electricity mergers to be considered as a means of promoting competitive market structures in the electricity industry.

In relation to the gas industry, the merger provisions of the Act and the regulatory framework of the gas code are able to protect competition in the gas industry. However, the potential removal of cross-ownership restrictions contained in Victorian gas

retail licences prohibiting significant producers from retailing gas could suggest consideration should be given to assessing whether measures in addition to the Act are necessary to protect competition. If such measures are considered desirable they should be consistent with the Act and be consistent with CoAG's current energy reform agenda.

The submission can be obtained from www.accc.gov.au; refer to 'multi-industry submissions and documents'.

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Electricity

Regulatory projects

TransGrid and EnergyAustralia

On 29 April 2005 the ACCC released its revenue cap decisions for TransGrid and EnergyAustralia for the 2004–09 regulatory period. Both TransGrid and EnergyAustralia made applications to the ACCC for a revenue cap in late 2003. In late 2004 TransGrid and EnergyAustralia submitted supplementary applications covering their future capital expenditure requirements in response to changes to the ACCC's capital expenditure framework.

The ACCC's decisions were based on recommendations made by PB Associates, GHD and Mountain Associates. In addition to these consultants' reports, the ACCC considered the information provided by TransGrid and EnergyAustralia and submissions made by interested parties. EnergyAustralia's and TransGrid's applications, consultants' reports, submissions and the decisions are available on the ACCC website.

Publication of Electricity Regulatory Report for 2003–04

On 8 April 2005 the ACCC released its annual Electricity Regulatory Report covering the financial performance of transmission network service providers (TNSPs) in the National Electricity Market. The report details the performance of ElectraNet, Powerlink, SPI PowerNet, Transend, TransGrid and VENCORP for the 2003–04 reporting year. The report is available on the ACCC website.

The report is prepared using information that the TNSPs provide to the ACCC annually. The ACCC believes the information should be published for the public benefit as it will increase transparency about the TNSPs' performance. This is the second annual report and the benefits of having a continuous data set available from which to draw performance trends are already identifiable.



The report focuses on the revenue and expenditure performance of the networks. Information is presented on the TNSPs' profitability and investment outcomes, comparing actual capital and operating and maintenance expenditure with the forecasts contained in the original revenue cap decisions. Ongoing reporting will assist the ACCC in identifying any areas of divergence between forecast and actual figures and determining the reasons for these differences.

Directlink

The ACCC is continuing with its assessment of Directlink's application for conversion from a market network service to a prescribed service and a maximum allowable revenue for 2005–15.

PB Associates and IES were engaged by the ACCC to assist in the review of Directlink's application. Their reports are available from the ACCC website. Comments from interested parties on the IES report were recently received by the ACCC and are also available on the website.

Authorisations

Authorisation of amendments to the National Electricity Code—dispatching the market: CSP/CSC trial at the Tumut nodes

On 8 February 2005 the ACCC received applications for authorisation (Nos A40097, A40098 and A40099) of amendments to the code. The applications were submitted by NECA.

The proposed derogation is designed to deal with a significant transmission constraint experienced between Murray and Tumut in the Snowy region. The proposal is for a simplified application of the Constraint Support Pricing (CSP)/Constraint Support Contracts (CSC) regime developed by Charles Rivers Associates (Asia Pacific) Pty Ltd.

The simplified trial is aimed at improving the pricing signal through providing a pseudo regional boundary between the Tumut and Murray nodes at times when congestion occurs on the Murray–Tumut transmission lines. This is coupled with a CSC allocation to Snowy Hydro Limited (Snowy Hydro) of 0MW for northward constraints and 550MW for southward constraints. The derogation is proposed to apply until 31 July 2007 at the latest.

On 15 April 2005 the ACCC released its draft determination proposing to grant authorisation to proposed amendments to part 8 of chapter 8 of the code. In response to the draft, Macquarie Generation requested a pre-determination conference which was subsequently held on 10 May at the Grace Hotel, Sydney. Further, the ACCC received seven submissions in response to the draft determination.

On 16 June 2005 the ACCC released its determination, granting authorisation to the applications for authorisation. The ACCC noted that the proposed arrangement will, on balance, produce net public benefits. In particular, the ACCC was of the view that the trial would result in more efficient outcomes by providing incentives on the dispatch of Tumut generation. The ACCC considered that this would induce competitive responses from Tumut generation leading to consistency between pricing and dispatch and will provide Tumut with the ability to compete with NSW generation on an equal footing. The ACCC noted that this would lead to increased incentives for the dispatch of Tumut generation at times when needed, contributing to reliability of supply to customers.

The ACCC noted comments relating to wealth transfers between Snowy Hydro, competitors and customers. The ACCC considered that these transfers did not involve any significant detriment that outweighs the benefits to the public. Further, the ACCC was of the view that any detriments would be limited by the short-term nature of the trial and the fact that it can be ceased by the Australian Energy Market Commission (AEMC) if it is leading to unintended consequences.

Authorisation of amendments to the National Electricity Code—extension of the reserve traders sunset

On 3 March 2005 the ACCC received applications for authorisation (Nos A90955, A90956 and A90957) of amendments to the National Electricity Code (code). The applications were submitted by the National Electricity Code Administrator (NECA).

The proposed code changes relate to clauses 3.12.1(a), 3.12.1(b) and derogations (chapter 8) part 7 section 2 and section 3. These amendments will allow the National Electricity Market Management Company (NEMMCO) to enter reserve contracts for a further 12 months, up until 1 July 2006.

On 27 April 2005 the ACCC granted authorisation to the proposed code changes. A copy of the determination is available on the ACCC website.

Authorisation to amendments to the National Electricity Code—B2B governance

On 4 March 2005 the ACCC received applications for authorisation of amendments to the code (Nos A90958, A90959 and A90960). The amendments are intended to standardise B2B governance arrangements for communications between distribution and retail companies operating in the National Electricity Market. The applications were submitted by NECA on behalf

of NEMMCO and NECA has subsequently requested an interim authorisation for the code changes.

On 13 April 2005 the ACCC granted interim authorisation to the applications.

The ACCC issued its draft determination on 11 May 2005 proposing to grant authorisation without condition. Following one submission on the draft determination, the ACCC expects to release a final determination in June 2005.

Authorisation of amendments to the National Electricity Code—amendments to ACT derogations—metering

On 18 March 2005 the ACCC received applications for authorisation (Nos A40100, A40101 and A40102) of amendments to the code. The applications were submitted by NECA on behalf of the Australian Capital Territory Chief Minister's Department.

The purpose of the applications for authorisation is to seek amendments to the ACT's derogations from chapter 7 of the code. The effect of the authorisation is that distribution businesses will continue to have exclusive responsibility for providing metering services to all small customers using types 5–7 metering installations until 31 December 2006.

The ACCC released a draft determination on 12 May 2005 which contained the ACCC's decision to grant interim authorisation to the derogations, with effect from that day.

The ACCC expects to release a final determination in June 2005.

Authorisation of amendments to the National Electricity Code—amendments to South Australian derogations—metering

On 18 March 2005 the ACCC received applications for authorisation (Nos A40103, A40104 and A40105) of amendments to the code. These applications were lodged by NECA on behalf of the South Australian Government.

The applications seek to amend clause 9.30.1 of South Australia's current metering derogations from chapter 7 of the code. The South Australian derogations make distributors exclusively responsible for metering installation types 5 (interval meters) and 6 (accumulation meters) for small customers and 7 (unmetered supply) for a transitional period until 1 July 2005.

The derogations also specify arrangements for payment of distributors' metering costs during this transitional period.

The applications seek to extend the duration of the derogations to 31 December 2006. The applications also seek to amend clause 9.30.1 to align it with



the ACCC's recent final determinations in relation to similar New South Wales and Victorian metering derogations. That is, the proposed derogation amendments will ensure that retailers may elect to be responsible for the provision, installation and maintenance of remotely read type 5 meters.

The ACCC released a draft determination on 12 May 2005 which contained the ACCC's decision to grant interim authorisation to the derogations, with effect from that day.

The ACCC expects to release a final determination in June 2005.

Authorisation of amendments to the National Electricity Code —NSW revenue cap derogation

On 26 April 2005 the ACCC received applications for authorisation (Nos A90969, A90970 and A90971) of amendments to the code. The applications were submitted by NECA on behalf of the Government of New South Wales.

The purpose of the applications for authorisation is to seek amendments to the National Electricity Code to implement revenue cap re-opening provisions specific to TNSPs in the New South Wales jurisdiction.

The ACCC expects to release a draft determination in July 2005.

Transport and prices oversight

Airservices Australia price notification

On 5 May 2005 Airservices Australia submitted a draft price notification to the ACCC to introduce interim price increases for its aviation rescue and fire fighting (ARFF) services for the period from 1 July 2005 to 31 December 2005.

The ACCC released its decision on Airservices' proposed price increases on 29 June 2005.

The ACCC did not object to the proposed temporary increases, pending a comprehensive review of the structure of ARFF charging.

Airservices' proposal followed the ACCC's preliminary view in 2004 in relation to Airservices' long-term pricing proposal, in which the ACCC expressed concern about the effect of applying the current basis for imposing ARFF charges, i.e. the maximum take-off weight of aircraft with a threshold of 2.5 tonnes.

Airservices' interim proposal, which increases the threshold under which airlines and other air

operators are subject to ARFF charges, addresses some of the ACCC's concerns with the current weight-based system of charges. However, the ACCC considered that it does not appear to address the ACCC's concerns about the efficiency of the structure of charges in the long term and the ACCC stated that Airservices needs to undertake a comprehensive review before introducing long-term prices for ARFF services.

The interim proposal will enable Airservices Australia to recover a greater amount of the costs of providing the ARFF services while it holds a review process with its customers to consider the structure of pricing for ARFF services to apply in the long term.

A copy of the ACCC's decision is available on the ACCC website.

Australia Post regulatory accounting framework

The ACCC issued record keeping rules (RKR) for Australia Post on 30 May 2005.

The RKR were issued under recent amendments made to the *Australian Postal Corporations Act 1989*, which allow the ACCC to require Australia Post to keep records that relate to the ACCC's functions of:

- prices surveillance
- inquiries into disputes about terms and conditions of access to Australia Post's bulk mail services
- monitoring for cross subsidy.

The RKR were issued following an extensive consultation process with Australia Post, and consultation with other parties who compete in the same markets. Issue of these RKR will enable the ACCC to examine claims that Australia Post is using its monopoly power in letters to the detriment of competition in other markets.

Australia Post is required to provide information under the RKR by 15 November 2005, in relation to the 2004–05 financial year and annually thereafter.

The RKR are available on the ACCC website.

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National Competition Council (NCC)

Certification matters

WA Electricity

Western Australia has recently completed the Electricity Networks Access Code 2004. Western

Australia intended to apply for certification of its access regime in June 2005.

Tasmanian gas access regime

The Tasmanian Government applied to the NCC for a recommendation that the State's access regime for gas pipeline services (the Tasmanian regime) is an effective access regime under s. 44M of the Trade Practices Act. If the regime is certified as effective, the services subject to the regime cannot be 'declared' for access under Part IIIA of the Act. In April 2005, the NCC forwarded the final recommendation to the relevant decision maker, the Parliamentary Secretary to the Australian Government Treasurer, the Hon. Chris Pearce MP.

Part IIIA matters

Lakes R Us application for declaration of water transport and storage services

Lakes R Us Pty Ltd have applied to the NCC for a recommendation for certain water storage and transport services provided by facilities operated by Snowy Hydro and State Water Corporation to be declared under Part IIIA of the Trade Practices Act.

In May 2005 the NCC released an issues paper seeking views on the Lakes R US application. Following a request from the applicant the deadline for submissions has been extended from 31 May to 24 June 2005.

FMG Rail access application

The NCC received four submissions on whether the service of the Mount Newman railway line in Western Australia meets the declaration criteria in s. 44G(2). The submissions were posted on the NCC's website on 14 June 2005. The council is now considering the issues and will release a draft recommendation for public comment.

Federal Court applications by FMG and BHPBIO are proceeding, with all evidence due to be filed by 9 September 2005.

Services Sydney—Australian Competition Tribunal

Applicant's evidence has been filed. Respondent's evidence was due 3 June 2005 but has not yet been filed.

Sydney Airport—Australian Competition Tribunal

Awaiting decision. As of 24 May 2005 the tribunal estimated that a decision would be 'several weeks away'.



Gas code matters

Moomba to Adelaide System

On 15 March 2005 the NCC received an application from Epic Energy South Australia Pty Ltd seeking revocation of coverage of the Moomba to Adelaide Pipeline System under ss. 1.24 and 1.25 of the gas code.

The NCC has invited and received public submissions in this matter and is now assessing the application against the coverage criteria set out in s 1.9 of the gas code. The NCC is required to release its draft recommendation by 16 August 2005 and will make its final recommendation to the South Australian Minister for Energy.

Dawson Valley pipeline

Molopo Australia Limited applied to the Council for a recommendation on coverage of Dawson Valley pipeline (QLD: PPL 26). Dawson Valley pipeline extends 47 km from Dawson Valley to

the Wallumbilla to Gladstone pipeline. The NCC is currently preparing a draft recommendation which is due for public release on 13 July 2005.

Policy and Legislation

Trade Practices Amendment (National Access) Bill

This Bill has been introduced. As a consequence of the Bill, and in particular the introduction of a four-month time frame for consideration of applications for declaration, the NCC is 'retooling' its processes for handling such applications.

The key changes that are likely include:

- dispensing with the issues paper step in the NCC's dealing with such applications
- requiring significantly more detail in applications for declaration under Part IIIA, including provision of experts reports as part of applications

- significantly shortened times for responses to applications and draft recommendations
- dissemination of revised guidelines and application templates.

Once implemented for Part IIIA applications it is likely that the amended approach, with necessary adaptations, will be applied to applications of coverage or revocation under the gas code.

Administrative matters

Nicole Ryan has joined the NCC secretariat staff on secondment from the ACCC. Martin Lockett has also been seconded to the council from the offices of the Australian Government Solicitor.

Michelle Groves, Nevenka Codeville, Andrew Trembath, Ravi Prasad and Alison Smith (who had been on extended parental leave) have taken up positions with other agencies or organisations. With Nevenka's departure the NCC's presence in Sydney has ended.



state developments

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Victoria

Essential Services Commission (ESC)

Energy

2006–10 Electricity Distribution Price Review

In March 2004 the ESC formally commenced the process of establishing a new set of price controls to apply to the Victorian electricity distribution businesses for the period commencing 1 January 2006. This new set of price controls will apply until 31 December 2010.

The ESC commenced the price review with the release of *Consultation Paper No. 1: Framework and Approach* which set out the framework and approach that the ESC proposed to use to come to a decision on the price controls that should apply from 1 January 2006. Further consultation papers on the service incentive arrangements and on the future regulation of excluded service charges were released, as well as a paper seeking comment from stakeholders on issues related to metering services.

In October 2004 the distributors submitted their price-service proposals to the ESC. The price-service proposals will be a central focus for the price review going forward and will provide the basis for analysis and discussion between the ESC, distributors and other stakeholders until the draft decision is released in June 2005.

On 14 December 2004 the ESC released an issues paper that identified key issues for public comment arising from the ESC's preliminary analysis of the distributors' price-service proposals. Submissions in response to the issues paper closed on 28 January 2005.

In March 2005 the ESC released a position paper that set out the ESC's preliminary view on the key issues arising in the price review. A draft decision is due on 22 June 2005, followed by a final determination in September 2005.

Information on the progress of the review and the consultation process is provided at the website the ESC has created for the price review. This website is located at www.esc.vic.gov.au/electricity699.html

Electricity Transmission Augmentation and Land Access Guideline

On 19 March 2004 the ESC released its issues paper 'Access to Land Held by a Transmission Company for Augmentation of the Electricity Transmission System' and received a total of six detailed submissions.

The purpose of the issues paper followed amendments to the *Electricity Industry Act 2000* that established the statutory framework for the resolution of land access for transmission augmentation, in accordance with the guidelines to be prepared and published by the ESC. The ESC also proposed combining the land access guideline with a guideline accommodating contestability for transmission works. An issues paper concerning this last matter was released by the ESC on July 2003.

Following significant consultation with key stakeholders the ESC released its draft combined guideline for comment by stakeholders in December 2004. Following review of submission on the draft combined guideline the ESC issued its final decision and guideline on April 2005.



Review of electricity and gas customer protection framework in full retail competition

The Victorian Government amended the energy legislation in late 2004 to provide for compensation for small customers who are disconnected from their energy supply other than in accordance with the terms and conditions of their contract. The ESC has published an Interim Operating Procedure—Wrongful Disconnection Compensation, after extensive consultation with retailers, consumer groups and other stakeholders including the Energy and Water Ombudsman Victoria (EWOV). The procedure gives guidance to stakeholders on how the relevant obligations in the Energy Retail Code should be interpreted in accordance with this statutory obligation, and will be reviewed in six months.

The Victorian Government has established a Committee of Inquiry into Financial Hardship of Energy Consumers, which is due to report in August 2005. The ESC provides advice and information to the Committee on request. The regulatory intention to mandate retailers to develop and implement hardship policies in accordance with broad objectives and principles has been deferred until the outcomes of the inquiry.

The ESC and ESCOSA have foreshadowed an intention to coordinate respective reviews of their Energy Retail Codes to determine whether all obligations should remain for larger energy consuming business customers, to maximise harmonisation of regulation across the jurisdictions.

Retail compliance, monitoring and reporting

The ESC has audited all local retailers on the obligations in the retail codes and disconnections and capacity to pay. Reports have been received in June and a preliminary report will be published in July 2005.

The draft 2004 Comparative Performance Report for retailers was published in June 2005 for relevant stakeholder comment. The final report will be published in late July 2005.

The revised performance indicators to better monitor whether customers who do not appear to have the capacity to pay their accounts are being disconnected by retailers took effect from 1 January 2005, and have enabled more focussed targeting of specific retailers for further investigation. Other jurisdictions are considering their national implementation through the Utility Regulators' Forum.

Price disclosure and comparison

The ESC's draft decision and guideline on the Victorian Government's statutory obligation on retailers to publish market offers on the internet will be published in early July. Further work will be undertaken in 2005–06 on a comprehensive interactive website price comparison tool, similar to those available for financial and other products.

National consistency and market monitoring

The ESC continues to consult with other jurisdictions to develop consistency in its customer protection regulatory instruments and convenes the Steering Committee on Energy Retail Consistency (SCERC) under the auspices of the Utility Regulators' Forum (URF).

In accordance with the URF directions, the committee continues to develop best practice models for marketing conduct and retail service standards, and other regulatory instruments, with the aim of achieving harmonisation across the jurisdictions in retail energy. This work will be coordinated with the MCE developments.

Market conduct

The ESC has coordinated regulatory activities with Consumer Affairs Victoria (CAV) in monitoring and enforcing market conduct regulation. This activity has involved three retail businesses in the past six months, including interstate retailers. The ESC continues to take a vigilant monitoring role in market conduct and determines the approach to compliance and enforcement with CAV, in accordance with the Memorandum of Understanding.

Energy retailer of last resort

The ESC has previously released a number of consultation and decision papers regarding the development of retailer of last resort (RoLR) schemes for the Victorian electricity and gas markets. The ESC released an issues paper on 14 October 2004 that drew together the outcome of those separate electricity and gas consultation processes and confirmed the decisions already made, with a view to developing a single energy RoLR scheme to apply in the electricity and gas markets. In particular, the paper focused on the development of a pricing proposal for the energy RoLR scheme. Submissions on the issues paper were accepted until 10 December 2004.

The ESC is currently in the process of reviewing the issues raised in the (nine) submissions. A draft decision paper was anticipated to be released in July 2005.

Natural gas extensions

The Victorian Government has committed \$70 million under the Regional Infrastructure Development Fund to assist with the provision of reticulated natural gas to towns in rural and regional Victoria through its Natural Gas Extension Program. The majority of program funds are being allocated to developers through a centralised competitive tender process, which is being administered by Regional Development Victoria (RDV). The ESC provided assistance to RDV in providing advice and information on the proposed regulatory treatment of projects conducted through the program.

The ESC anticipates a number of the tender outcomes will thereafter seek regulatory approval under the National Gas Code. The ESC has considered and issued final decisions with respect to applications from Envestra in relation to the provision of natural gas to the East Gippsland towns of Bairnsdale and Paynesville. Both proposals sought the ESC ex ante approval under s. 8.21 of the National Gas Code that the forecast new facilities investment to reticulate Bairnsdale and Paynesville meet the requirements of s. 8.16(a) of the code. The ESC released its final decision on the Envestra's Bairnsdale proposal on 12 May 2004 and for the Paynesville proposal on 30 July 2004.

TXU (SPI) Networks also made a similar application, on 22 December 2004, for ex ante approval under s. 8.21 of the National Gas Code that the forecast new facilities investment for the reticulation of some 12 towns including Macedon Ranges (including Woodend, Macedon, Riddell's Creek, Romsey, Lancefield, Gisborne and New Gisborne), Creswick, Camperdown, Barwon Heads, Port Fairy and Maiden Gully meets the s. 8.16 (a) requirements of the National Gas Code.

Following consideration of stakeholder submissions on both the application itself and the ESC draft decision (released 29 March 2005) the ESC released its final decision approving the application on 18 May 2005.

Multinet has also sought approval from the ESC for its application to extend reticulated natural gas to the Yarra Ranges. The ESC is currently in the process of analysing the proposal. A draft decision is expected by the end June 2005.

Gas meter contestability

The Retail Gas Market Rules require that the ESC review the exclusive responsibility for the provision of certain gas metering services assigned to the gas distribution businesses and VENCORP.



These services are:

- the provision of meters to customers
- the provision of basic meter and interval meter reading
- the provision of basic meter/data management and interval meter data management
- meter data profiling services.

The ESC has analysed the cost benefit of changes from the current arrangements and released its draft decision on 2 August 2005.

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South Australia

Essential Services Commission of South Australia (ESCOSA)

Corporate

Acting Chair appointed

Following the resignation of Lew Owens, Dr Patrick Walsh (the current Director Licensing and Performance Monitoring of ESCOSA) has been appointed Acting Chair of ESCOSA for a period of six months commencing on 11 April 2005, or such lesser time on the appointment of an on-going Chair. Dr Walsh has held his current position with ESCOSA since January 2000.

Commissioner Baker—resignation

The Hon. Stephen Baker announced his resignation from ESCOSA to take effect at close of business Friday 15 April 2005. Stephen left ESCOSA to take up a position overseas which precluded him from continuing in his role as part time commissioner.

Energy

Prepayment Meter System Code

ESCOSA has made a new Prepayment Meter System Code, with effect from 19 May 2005, which establishes a regulatory framework for prepayment meters in South Australia. Prepayment meter systems are non-standard electricity or gas meters, or an additional functionality of a standard gas or electricity meter designed to allow for the prepayment of electricity or gas through mechanisms such as token, electronic ticket, smart card or keypad technology. The new code is the result of work undertaken by ESCOSA and considerable stakeholder input since February 2004.

In developing the code ESCOSA has focused strongly on identifying and addressing consumer issues with prepayment meters and developing a suitable consumer protection framework.

Monitoring the development of energy retail competition in South Australia

ESCOSA in its FRC monitoring final decision paper (released in September 2004) advised that it would move to releasing six-monthly substantive FRC monitoring reports (September and March), and that it intended to commence the routine reporting of monthly electricity and gas transfer statistics. The first of the six-monthly substantive reports was released in September 2004, with the second six-monthly report released in March 2005.

The March report provides an analysis of this stage in the development of retail competition in South Australia, and in summary shows:

- The gas retail market has opened well, with around 55 000 small SA gas customers transferring to market contracts as at the end of February 2005, representing 15 per cent of the small gas customer base of around 365 000 customers.
- Notwithstanding the expiry of the state government's \$50 electricity transfer rebate offer in August 2004, there are still a considerable number of electricity transfers occurring each month. As at the end of February 2005, there had been around 250 000 small customer completed transfers to market contracts in the SA electricity retail market, representing 34 per cent of the small electricity customer base of around 740 000 customers.
- There are now six retailers selling electricity to small customers in SA, with four of these operating in the gas retail market.
- There has been an improvement in the level of potential savings in moving to an electricity market contract.

ESCOSA has also commenced providing information on monthly small customer transfer statistics. As at 31 May 2005:

- There had been around 280 000 small customer completed transfers to electricity market contracts since commencement of electricity FRC on 1 January 2003, representing 38 per cent of the small customer base of 740 000.
- There had been around 90 000 small customer completed transfers to gas market contracts since commencement of gas FRC on 28 July 2004, representing 25 per cent of the small customer base of 365 000.

Amendment to Energy Customer Transfer and Consent Code

On 13 April 2005 ESCOSA amended the Energy Customer Transfer and Consent Code (ECTC/01), which deals with certain processes for the transfer of customers between retailers in competitive electricity and gas markets. The amended code took effect on 1 May 2005.

The amendments provide that the transfer of a gas customer with an interval meter may be based on an estimated meter reading where the use of an estimated meter reading is permitted by the Retail Market Rules.

Electricity

2005–10 Electricity Distribution Price Review

On 5 April 2005 ESCOSA released its final price determination on ETSA Utilities' distribution charges for all customers for the period 1 July 2005 to 30 June 2010. The final determination was the culmination of over three years' work by ESCOSA and substantially confirmed ESCOSA's December 2004 draft decision.

The final determination balanced the need to keep electricity distribution prices as low as possible with the need to provide ETSA Utilities with sufficient funds to deliver safe and reliable electricity supplies, to invest in the maintenance and improvement of the electricity distribution network across the State, to replace aging infrastructure and to provide incentives for demand management.

Peak demand continues to be a key driver of the need for new network investment and therefore capital expenditure. Based on an assumed 3 per cent per annum growth in peak demand and a 1.4 per cent per annum growth in energy sales, ESCOSA's determination is to provide, over the five year period, for a total capital expenditure benchmark of \$753 million (40 per cent higher than in the current regulatory period); and a total operating expenditure benchmark of \$649 million (approximately 24 per cent greater than current levels).

The final determination resulted in a modest fall in network charges for the average household of about \$60 per year from 1 July 2005. Network prices will increase by CPI in each subsequent year of the regulatory period.

On 19 April 2005 ETSA Utilities lodged a review application under Part 6 of the *Essential Services Commission Act 2002* for a review of ESCOSA's electricity distribution price determination.



The key areas in respect of which ETSA Utilities sought a review were:

- ESCOSA's decision to set a value of \$6 million for the easements held by ETSA Utilities as at 1 July 1999 (ETSA Utilities considers that ESCOSA should set a value of \$224.45 million in respect of those easements and index that value to July 2005 dollars for the purposes of the price determination)
- ESCOSA's decision, in setting ETSA Utilities' permitted regulatory rate of return, to set a parameter of 0.8 for the equity beta component of the CAPM (ETSA Utilities considers that ESCOSA should set a parameter of not less than 1.0).

As required under Part 6, ESCOSA invited the Treasurer to join as a party to the review and to make submissions on the review application. ESCOSA was required to make a decision on the review by Tuesday 31 May 2005.

On 30 May ESCOSA made a decision on the review application from ETSA Utilities. In summary, ESCOSA has:

- rejected ETSA Utilities' view concerning the value of easements to be included in the regulated asset base, reaffirming ESCOSA's original determination that the value of easements should be set at \$6 million as at 1 July 1999
- rejected ETSA Utilities' view that the value of the equity beta component of the CAPM should be set at not less than one. However, ESCOSA has determined that the value of equity beta should be set at 0.9.

The decision to change the value of equity beta to 0.9 has the consequential effect of changing the X-factor within the CPI-X formula within the price determination published on 5 April. The decision will not, however, have any immediate impacts on customer tariffs for 2005–06, and preserves the current savings on average residential customers' bills from 1 July 2005. The variation in the X-factor will only have effect from 2006–07, with the impact on the average residential customer's bill arising from ESCOSA's decision on the value of equity beta being approximately \$3 per annum from that time.

Electricity Distribution Price Review: Associated Review of Licence and Codes

In February 2005 ESCOSA released a discussion paper outlining proposals for amendments to the Electricity Distribution Licence, Electricity Distribution Code, Electricity Metering Code and the South Australian Electricity Supply Industry Metrology Procedure. The proposed amendments arose principally from the Electricity Distribution Price Review (EDPR) process. ESCOSA received four submissions on the discussion paper.

ESCOSA has now released its draft decision on the review of licence and codes associated with the EDPR. The draft decision reflects the outcomes contained in the final 2005–10 Electricity Distribution Price Determination, particularly in relation to the new service standard framework to apply from 1 July 2005. It also takes into account submissions received in relation to various other licence and code changes proposed in the discussion paper. Included as attachments to the draft decision are draft amended versions of the various regulatory documents. ESCOSA intended to release its final decision on licence and code amendments by late June 2005 with the varied licence and codes to take effect from 1 July 2005.

Embedded Generation Guides and Connection Requirements: Consultation Draft

In February 2005 ESCOSA released a consultation draft document covering proposed changes to the regulatory framework for embedded generators in South Australia.

A key focus of the document concerns connection requirements for small embedded generators (e.g. roof-top photovoltaic systems). Amendments are proposed to chapter 2 of the Electricity Distribution Code to address barriers to embedded generation in South Australia.

It is anticipated that the code changes will take effect from July 2005.

Electricity Retailer of Last Resort (RoLR) Discussion Paper

In March 2005 ESCOSA released a discussion paper, which addresses a range of issues involved in developing electricity RoLR arrangements for South Australia, including processes for retailing to affected customers should a RoLR-event (i.e. unplanned exit of an electricity retailer from the market) occur, and tariffs and terms and conditions for RoLR contracts.

The paper identified a number of legal, technical and practical issues that will need to be resolved before a workable electricity RoLR scheme can be implemented for South Australia. ESCOSA is currently considering the submissions received, with the view of releasing a decision paper in the coming months which would outline a process for implementing a workable electricity RoLR scheme for South Australia.

Amendments to Chapter 3 of the Electricity Distribution Code: Augmentation

Chapter 3 of the Electricity Distribution Code outlines procedures for establishing new connections, or modifying existing connections,

that require extension and/or augmentation of the electricity distribution network. ETSA Utilities is required to comply with the provisions of chapter 3 as a condition of its distribution licence. ESCOSA has been reviewing aspects of chapter 3 over the past few years.

In March 2005 ESCOSA released a final decision outlining its conclusions on the nature of the augmentation charging regime that is proposed to take effect from 1 July 2005, and proposing further amendments to chapter 3 to implement this regime. To complement the augmentation charging provisions in chapter 3 it was necessary to develop an associated guideline (Electricity Industry Guideline No. 13) to specify more detailed augmentation charging arrangements with which ETSA Utilities must comply, and to outline the application of chapter 3 to specific types of developments.

The amendments to chapter 3 as outlined in the final decision, and the associated guideline No. 13, will take effect from 1 July 2005.

SA Electricity Standing Contract Prices for 1 July 2005–30 June 2006

In December 2004 ESCOSA made a price determination to apply to electricity standing contract prices for small customers.

On 5 May 2005 in accordance with section 2.6.1 of the price determination, AGL SA submitted a statement to ESCOSA for the standing contract prices that would apply for the period 1 July 2005 to 30 June 2006.

The standing contract prices are made up of the retail tariff components and the network tariff components. Given that ESCOSA has now reviewed both these components that will apply from 1 July 2005 to 30 June 2006, AGL SA has submitted a combined set of tariffs.

ESCOSA has reviewed this set of tariffs and approved them as standing contract prices that will apply for the period 1 July 2005 to 30 June 2006.

Licensing

Issue of Electricity Generation Licence to Carter Holt Harvey Wood Products Australia Pty Limited

On 23 May 2005 ESCOSA issued a licence to Carter Holt Harvey Wood Products Australia Pty Limited to generate electricity at its Radius wood-waste plant located on the Jubilee Highway East in Mt Gambier. The plant is connected to the ETSA Utilities 33 kV distribution network and is expected to have a maximum capacity (after site upgrades) of 9.5 MW.



Issue of electricity generation licence to Pacific Hydro Clements Gap Pty Ltd

On 3 June 2005 ESCOSA issued an electricity generation licence to Pacific Hydro Clements Gap Pty Ltd (PHCG) to generate electricity at the Clements Gap wind farm, located on a 10 km stretch of the Barunga Ranges in the Port Pirie region, some 15 km north-west of Redhill and 15 km south-west of Crystal Brook. The wind farm will have a maximum installed capacity of 57.8 MW and will be connected to a substation which, in turn is connected to ElectraNet's 132 kV transmission line that runs from Port Pirie to Hummocks.

PHCG had applied for a licence in August 2004. The issue of this licence means that ESCOSA has now licenced wind farms with a total capacity of about 450 MW. Of this amount, about 320 MW is now operational.

Generation licences for wind farms—applications

Since January 2005 ESCOSA has received the following applications for the issue of generation licences pursuant to Part 3 of the *Electricity Act 1996*:

- On 10 January 2005 from AGL Power Generation (Brown Hill) Pty Ltd for the issue of a generation licence for a wind farm with a total output capacity of between 90 MW and 135 MW. The wind farm site is located on the ranges adjacent to AGL's existing Hallett Power Station, in the mid-north of South Australia.
- On 18 March 2005 from AGL Power Generation (Brown Hill) Pty Ltd relating to a wind farm at 'The Bluff', with a total output capacity of between 45 MW and 75 MW. The Bluff development is also located on the ranges adjacent to AGL's existing Hallett Power Station, in the mid-north of South Australia.
- On 24 March 2005 from Waterloo Wind Farm Pty Ltd for the issue of a generation licence for a wind farm with a maximum output capacity of 117 MW. The wind farm is to be located approximately 5 km east of Waterloo and 30 km south-east of Clare, in the mid-north of South Australia.
- On 29 March 2005 from Stanwell Corporation Limited for the issue of a generation licence relating to a wind farm with a maximum output capacity of 123 MW, to be located on the Barunga Ranges, approximately 150 km north-west of Adelaide and 40 km south-east from Port Pirie, in the mid-north of South Australia.

- On 29 March 2005 from Worlds End Wind Farm Pty Ltd for the issue of a generation licence relating to a wind farm with an output capacity of 180 MW. The wind farm is to be located on the plains north of Burra Creek Gorge, approximately 10 km south-west of Burra, in the mid-north of South Australia.
- On 8 June 2005 from Wind Prospect Pty Ltd for the issue of a generation licence relating to a wind farm with a capacity of 30 MW. The wind farm is to be located in the state's mid-north, across a ridge of the North Mount Lofty Ranges, directly west of the Mt Bryan township.

As at 31 December 2004 ESCOSA had before it generation licence applications for four wind farms with the total installed capacity of about 600 MW. Taking into account the additional generation licence applications for wind farms received since 31 December, that figure has risen to about 1250 MW. ESCOSA has referred each of those applications to the Electricity Supply Industry Planning Council (ESIPC) for specific advice regarding the system security, reliability and market impact associated with such a significant amount of wind generation capacity in the South Australian power system.

ESIPC provided general advice to ESCOSA on such matters in a report released in April 2005. ESCOSA has also liaised extensively with NEMMCO on these issues. In June ESCOSA released for comment a paper outlining a draft set of principles to guide the future issuing of generation licences for wind farms in South Australia. These principles seek to ensure that wind farms are subject to appropriate technical standards and are more fully integrated into the market arrangements applicable to conventional generators.

Electricity and gas retail licence application: Jackgreen (International) Pty Limited

ESCOSA has received an application from Jackgreen (International) Pty Limited for the issue of a licence to retail electricity and gas to customers in South Australia pursuant to Part 3 of the *Electricity Act 1996* and Part 3 of the *Gas Act 1997*. Jackgreen (International) Pty Limited plans to sell electricity predominantly to small electricity customers.

Electricity retail licence application: Ergon Energy Pty Ltd

ESCOSA has received an application from Ergon Energy Pty Ltd for the issue of a licence to retail electricity to customers in South Australia. Ergon Energy Pty Ltd plans to sell electricity to customers consuming more than 160 MWh per annum.

Electricity and gas retail licence application: Energy Australia Pty Ltd and IPower Pty Limited

In May 2005 ESCOSA received an application from Energy Australia Pty Ltd and IPower Pty Limited for and on behalf of the EnergyAustralia—International Power (Retail) Pty Ltd Retail Partnership, for the issue of a licence to retail electricity and gas to all classes of contestable customers in South Australia. ESCOSA issued this licence on 15 June 2005.

SPI Australia Group Pty Ltd—transfer of retail electricity and gas licences in South Australia

On 13 April 2005 ESCOSA approved an application from SPI Electricity Pty Ltd to transfer its electricity and gas retail licences to SPI Retail Pty Ltd. SPI Electricity holds licences to retail electricity and gas in South Australia under both the *Electricity Act 1996* (SA) and *Gas Act 1997* (SA).

GAS

Gas standing contract price path inquiry: discussion paper

In December 2004 Origin Energy presented a submission to ESCOSA proposing a three-year price path for gas standing contract supply commencing 1 July 2005.

In accordance with the Gas Act, ESCOSA was required to conduct an inquiry into the appropriate prices for standing contract supply, having regard (among other things) to the Origin Energy submission.

ESCOSA released an issues paper on 23 December, and received five submissions in response to the issues paper.

ESCOSA subsequently prepared and released a discussion paper based on the above submissions and further analysis of the Origin Energy proposal, with comments sought by 3 June 2005.

ESCOSA will release its final inquiry report and final price determination in late June. The final price determination will take effect from 1 July 2005 and regulate the gas standing contract prices for the period 1 July 2005 to 30 June 2008.

Gas retail market administrator price determination

On 16 March 2005 ESCOSA made a price determination concerning prices for the provision of retail market administrator services in the gas market in South Australia (being the services provided by REMCo). The new determination varies an earlier price determination made on 1 July 2004.



The main variation involves resetting the price caps applying to the market share charge, based on updated financial information. A retail market administrator can charge up to the 'price caps' set out in the price determination without the prior approval of ESCOSA.

The variations take effect from the date of publication of a notice in the South Australian government gazette (Thursday 24 March 2005).

2006 Review of Envestra's gas distribution access arrangement: discussion paper

ESCOSA is the local regulator under the *Gas Pipelines Access (South Australia) Act 1997* for the South Australian gas distribution system. Envestra is the owner and operator of that gas distribution system. In accordance with the terms of the current access arrangement applying to the South Australian gas distribution system approved under the National Third Party Access Code for Natural Gas Pipeline Systems, Envestra is required to submit to ESCOSA, on or before 1 October 2005, the revisions Envestra proposes to that access arrangement. The commencement date for revisions finally approved by ESCOSA is 1 July 2006.

ESCOSA has decided to undertake a preliminary consultation process on selected matters prior to Envestra formally submitting its proposed access arrangement revisions for approval. This process commenced with the publication of an issues paper in November 2004.

ESCOSA has now published a discussion paper, which develops ESCOSA's preliminary views on certain matters in response to the views expressed in submissions received on the issues paper and in light of ESCOSA's own analysis of the requirements of the National Gas Code. ESCOSA has sought written submissions from interested parties on the options canvassed in the discussion paper and ESCOSA's preliminary views on those options, and on any other matters that parties consider appropriate.

A guidance paper, setting out ESCOSA's views in light of submissions made in response to the discussion paper, will be published by end-July 2005, two months before Envestra is due to submit its proposed Access Arrangement Revisions.

Envestra's reference tariffs to apply from 1 July 2005

In accordance with s. 8.3B of the National Third Party Access Code for Natural Gas Pipelines, on 20 May 2005 Envestra wrote to ESCOSA seeking approval to increase reference tariffs from 1 July 2005. ESCOSA has approved Envestra's application on the basis that it complies with all relevant requirements of the access arrangement.

Receipt of submissions for changes to the Gas Retail Market Rules

In the period March to June 2005 ESCOSA has received three submissions from REMCo (Retail Energy Market Company Ltd) for changes to the Gas Retail Market Rules which govern the operation of the gas retail market in South Australia.

The Minister for Energy approved the initial set of RMR in June 2004, prior to commencement of the gas retail market on 28 July 2004. REMCo is required to submit to ESCOSA for its approval any proposals for amendments to the RMR. Regulation 5(3b) of the Gas Regulations 1997 establishes a process to be used by ESCOSA in considering proposed RMR amendments.

Licensing

Variation of gas retail licences

On 23 July 2004 the SA Gas Regulations 1997 were amended to (inter alia) require ESCOSA to include in gas retail licences a condition requiring the licensee 'to ensure that at all times the quantity of gas available to it for delivery to its customers from a distribution system is sufficient to meet reasonable forecasts of its customers' aggregate demand for gas from the distribution system'.

Following a consultation process, ESCOSA, pursuant to section 29 (2)(b) of the *Gas Act 1997*, has varied each gas retail licence to accommodate the requirement with effect from 29 March 2005.

Transport

Amendment to Ports Industry Guideline No. 2

Subsequent to changes to the Ports Access Regime in 2004, ESCOSA has amended Ports Industry Guideline No. 2: Regulatory Accounts to include certain cargo infrastructure services adjacent to grain berths in the reporting structure.

Tarcoola–Darwin Railway: Compliance Guideline

ESCOSA has adopted a guideline under the AustralAsia Railway (Third Party Access) Code covering compliance systems and reporting. The guideline applies to any access provider under the code. The guideline provides a framework by which ESCOSA can fulfill its obligation under the code to 'monitor and enforce compliance with' the code.

The commencement date is 1 June 2005.

Tarcoola–Darwin railway DORC valuation

ESCOSA has finalised its acceptance of the valuation of the Tarcoola–Darwin railway for regulatory (ceiling price) purposes. As previously agreed by

ESCOSA, the valuation was prepared by Booz Allen Hamilton for the railway operator Asia Pacific Transport in line with directions from ESCOSA.

In accordance with Rail Industry (Tarcoola–Darwin) Guideline No. 2, it is based on the depreciated optimised replacement cost (DORC) methodology.

The total valuation is \$1696.9 million, comprising \$1159.1 million for the Darwin–Alice Springs section and \$537.8 million for the Tarcoola–Alice Springs section.

South Australian rail access regime – review of regulator components: issues paper

ESCOSA has commenced a review of the components of the South Australian Rail Access Regime for which it has responsibility.

The components under review broadly concern:

- pricing principles
- information provision to access seekers
- regulatory reporting.

The regime arises under the *Railways (Operations and Access) Act 1997*. The current regulatory arrangements, and further information on the regime including its coverage, is explained in the ESCOSA publication Information Kit: South Australian Rail Access Regime.

Water

Inquiry into 2005–2006 metropolitan and regional water and wastewater pricing processes: final report

Pursuant to section 35(1) of the *Essential Services Commission Act, 2002* the treasurer referred to ESCOSA an Inquiry into the 2005–06 Metropolitan and Regional Water and Wastewater Pricing Processes. In undertaking the Inquiry, ESCOSA considered a document 'Transparency Statement—Water and Wastewater Prices in Metropolitan and Regional South Australia 2005–06 (Part A)' dated December 2004.

On 30 March 2005, ESCOSA forwarded to the Treasurer and the Minister for Administrative Services the 'Final Report—Inquiry into 2005–06 Metropolitan and Regional Water and Wastewater Pricing Process'.

As required by the Act, the final report was tabled in both houses of parliament on Monday 23 May 2005.

Independent Pricing and Regulatory Tribunal (IPART)

Electricity distribution

Demand management guidelines

As part of the 2004 Electricity Determination, IPART introduced a 'D-factor'. The D-factor provides a way for DNSPs to pass the costs of undertaking efficient demand management (DM) investment through into prices. It is intended to encourage DNSPs to consider DM options on at least an equal footing with network augmentation options, when they plan how to address a demand–supply constraint. IPART stated that it would issue guidelines to assist stakeholders in understanding the application of the D-factor and other aspects of IPART's approach to DM investments.

IPART convened a DM working group, made up of distributors and other stakeholders, to draft guidelines. The draft guidelines were published for comment, and IPART has now issued final guidelines, which are available on the IPART website. The DM guidelines cover:

- calculation of avoided distribution costs for use in the D-factor¹³
- calculation of foregone revenue for use in the D-factor
- loss management investments
- a note on distributor network planning processes.

EnergyAustralia public lighting price proposals

In March 2005 IPART wrote to EnergyAustralia asking it to submit alternative public lighting price proposals, on the grounds that IPART did not consider EnergyAustralia's initial proposals (which involved an average increase of 26 per cent real, with further price increases planned for subsequent years) meet the requirements of Clause 2.3 of Rule 2004/01 as set out in the 2004 Electricity Distribution Network Determination. Clause 2.3 includes a requirement that distributors consider the customer effects of their price proposals.

EnergyAustralia has now submitted alternative public lighting price proposals, involving a real increase of 10 per cent in 2005. IPART is currently consulting on these proposals.

Gas

2004 review of access arrangements

In December 2004 IPART released its draft decision on AGLGN's proposed revisions to its access arrangements. Public submissions on the draft decision were due 28 February. IPART released a final report in April 2005 with the revised access arrangement commencing on 1 July 2005.

The next review of the access arrangement of Country Energy Gas (CEG) will also occur in 2005. Country Energy's proposed revised access arrangement is also on the IPART website. A draft report is scheduled for release in Mid 2005.

Transport

IPART has a five-year standing reference to recommend fare changes for private transport operators. IPART finalised its recommendations to the Director General of the Ministry of Transport on 9 June 2005 for taxis and the industry awaits the Director General's determinations.

IPART has also commenced its annual review of NSW bus and ferry fares and expects to make determinations on metropolitan buses and Sydney Ferries' fares by end-2005. It will also make recommendations to the Director General on private non-metropolitan bus fares and private ferry fares by end-2005.

Water pricing

Metropolitan water pricing

IPART has recently determined water and wastewater prices to be charged by Gosford and Wyong Councils for the 2005–06 year. IPART is also reviewing prices charged by Sydney Water, Sydney Catchment Authority and Hunter Water, from October 2005 for Sydney Water Corporation and the Sydney Catchment Authority and November 2005 for Hunter Water Corporation. As part of this process IPART has recently released a draft determination for a four-year price path for public comment.

IPART engaged a consortium of WS Atkins and Cardno MBK to review the asset management, operating costs and capital expenditure of the businesses. An overview report from Atkins/Cardno has been placed on the IPART website. IPART also engaged MMA to undertake a review of the reasonableness of each agency's consumption forecast and to make recommendations about consumption assumptions for the purposes of price setting. MMA's report is also available on IPART's website.

Bulk water pricing

IPART has begun a review of the charges to apply from 1 July 2005 for the extraction of bulk water by farmers, industrial users and town water suppliers from water sources managed by the Department of Infrastructure, Planning and Natural Resources (under the Water Administration Ministerial Corporation) and State Water.

IPART has decided to issue a one-year determination and anticipates that this will be released on or around 30 June 2005. IPART anticipates the review to set a longer term prices path will begin in September 2005.

Water licensing

IPART has completed its review of the operating licence for Sydney Water Corporation. The Sydney Water licence is to take effect from 1 July 2005. The Minister for Energy and Utilities has tabled the new licence in parliament.

IPART has completed a review to recommend terms and conditions for inclusion in State Water's initial (3-year) operating licence, which will take effect from 1 July 2005. (State Water currently has an interim licence).

IPART is currently reviewing the operating licence for the Sydney Catchment Authority. A public workshop is being held on 8 July 2005. The new licence is to take effect from January 2006.

IPART released an issues paper for this review in early September. A public workshop was held in Sydney on 10 December 2004. IPART is to report to the minister by 31 May 2005.

Greenhouse Gas Abatement Scheme

The Greenhouse Gas Abatement Scheme began on 1 January 2003. The scheme imposes greenhouse gas emission targets on electricity retailers as benchmark participants. The primary way benchmark participants meet the targets is through the surrender of abatement certificates (NGACs).

The relevant legislation outlines the emissions targets for the period to 2012. The Premier of NSW recently announced that the scheme would be extended to 2020.

More information about the scheme is available in *Network 16*.

IPART effectively has two roles in the scheme. As compliance regulator it ensures that benchmark participants meet emissions reduction or offset targets set in legislation. As scheme administrator it is responsible for accrediting abatement certificate providers. Certificates can be provided by electricity

¹³ Avoided distribution cost sets a cap on the amount of (non-tariff based) DM implementation costs that a DNSP can pass through under the D-factor.



generators producing low or reduced emissions electricity, organisations undertaking demand side abatement, and through carbon sequestration in forestry. The scheme administrator also maintains the abatement certificate registry.

The administrative processes supporting the scheme were fully implemented by August 2003. Full details of the scheme, including application forms, guides to applying and other documents are available from the scheme website at www.greenhousegas.nsw.gov.au. IPART has published a number of case studies of successful applications. These explain how each applicant was accredited, the costs of auditing their application and the ongoing conditions of accreditation to which they are subject.

For the 2004 compliance year, there were 31 benchmark participants (23 of these were compulsory participants, as prescribed in the legislation). As at 20 June 2005 IPART had accredited 135 projects that are eligible to create certificates. By that date a total of 15 050 727 abatement certificates had been registered in the scheme. Details of accredited abatement certificate providers and the certificates they have registered are available at www.ggas-registry.nsw.gov.au.

At this stage of the scheme's development there are more certificates being created than are needed for surrender by benchmark participants. However, abatement certificates are bankable enabling those registered early in the scheme to be used for compliance in future years. The number of certificates required for benchmark participants to meet the benchmark levels in future years will be significantly higher. This should provide an incentive for the development of more abatement projects in both the short and medium term.

Other reviews

IPART also undertakes reviews outside the utility regulation functions at the request of the NSW Government or others. Recently completed and current reviews include:

- A review into the Infrastructure Services Strategy for the Perisher Range Resorts: including developing pricing principles and recommending prices and charges. An issues paper and call for submissions was released on 13 September 2004, with submissions due on 25 October 2004. A round table was held on 16 March 2005. The report is envisaged to be finalised by June 2005.
- A review of rentals for Crown Land Communication Tower Sites: an issues paper was released on 27 September 2004 with submissions being due on 5 November 2004.

In February 2005 IPART released background material to facilitate discussion at a roundtable which was held on 9 March 2005. IPART will release a draft report in July before presenting its final report to the relevant ministers on 30 September 2005.

- A review of arrangements for the delivery of water and wastewater services in the greater Sydney metropolitan area: IPART is examining current arrangements with a view to recommending options for service provision, including possible private sector involvement, in the most efficient, effective and sustainable way. An issues paper calling for submissions was released on 6 May 2005, with submissions due by 31 May 2005. IPART expects to release a draft report in early August, with a public workshop scheduled for 16 August 2005. A final report will be presented to the government by 31 October 2005.
- IPART is also reviewing some financial aspects of the Ambulance Service of NSW in response to terms of reference issued by the premier. IPART has published an issues paper on its website as part of a public submissions process. IPART expects to submit a report with recommendations to the Minister of Health in mid-September 2005 and a second report on the role of cost indices in future fee setting by end November 2005.

Independent Competition and Regulatory Commission (ICRC)

Electricity

Network price reset for 2005–06

In preparation for the 2005–06 financial year, the ICRC reset prices for a range of services including electricity distribution network services. The price resetting process requires assessment of price proposals for the 2005–06 financial year brought forward by the network service provider. The ICRC's role is to determine whether the proposed prices accord with the current price determination. 2005–06 is the second financial year of the current five year electricity network price path, which began in 2004–05. The prices proposed by ActewAGL Distribution were endorsed as being consistent with the ICRC's current price determination.

Retail electricity pricing

The ACT opened the electricity retail market to full retail contestability from 1 July 2003, subject to a three year transitional period. The transitional arrangement provides for a 'safety net' price for

those customers who do not wish to move to the contestable market price. For the transitional period the ICRC established the transitional franchise tariff (TFT). The continuation of a transitional tariff is to be reviewed before the end of the three year transitional period, which ends 30 June 2006. The ICRC expects that a reference for a review of the TFT arrangements may be issued in September 2005, so that a new TFT, if required, will apply to an extended transitional period.

Metrology procedures review

Following the Joint Jurisdictional Review of Metrology Procedures released in 2004, the ICRC has commenced a review of metrology procedures in the ACT. The review of the ACT procedures is to determine:

- whether the recommendations of the Joint Jurisdictional Review should be adopted in the ACT
- what changes would be required to the current ACT procedures to give effect to the recommendations
- what enhancements might be made to metrology procedures in the ACT arising from the Joint Jurisdictional recommendations to progress development of the retail electricity market.

The review acknowledges the need to recognise the changes that are taking place nationally in terms of metrology, market regulation and COAG policy developments to which governments are committed (electricity efficiency and demand management for example). The ICRC expects to release its draft report on metrology procedures in the ACT in August 2005.

Regulation of greenfields electricity infrastructure development

The ICRC released its report on competition in customer funded greenfield electricity infrastructure development in 2004, recommending that the market be made contestable. The government decided to maintain the existing monopoly arrangements for greenfield developments, having regard to the uncertainty in the market as it moved towards national regulation. It noted that the ICRC would be developing and applying some form of appropriate regulation to ensure that consumer's interests were protected.

The ICRC released an issues paper on possible customer funded greenfield infrastructure regulation for public comment in August 2005. The ICRC expects to release a draft report by October and a final report before the end of the year.



Incentives carryover and service quality mechanisms

The ICRC raised the question of incentive carryover mechanisms and service quality incentives in its reviews of electricity and water network pricing in 2004. The ICRC released an issues paper in March 2005 and a draft report on incentive mechanisms in August 2005, and expects to issue a final report on the possible adoption of special mechanisms by the end of 2005. The ICRC's draft position for all three utility network services is that adopting such mechanisms would not be efficient at this time and in the circumstances prevailing in the ACT.

The ICRC notes that other jurisdictions have also considered this issue. This includes Victoria, which introduced specific incentive mechanisms for efficiency and service quality. In the ACT the ICRC's draft report concludes that the current service quality standards and reporting arrangements are adequate and there is not a need to consider implementing a specific service standard incentive mechanism when the current arrangements are meeting consumer expectations and requirements. Efficiency carryover mechanisms are considered in some detail, particularly the question of whether they achieve their purpose. The draft report concludes that it would not be appropriate to introduce such a mechanism at this time, as there is some doubt as to whether the mechanisms in the form in which they are actually applied, achieve their desired objective.

Gas access

Gas access prices

The ICRC reset the gas access price for network services in 2004 for the period 1 January 2005 to 30 June 2010. The prices proposed for access in 2005–06 were agreed as being within the parameters set under the current access arrangements approved in 2004.

Water

Water price reset for 2005–06

As for gas access and electricity, prices for water services were reset for the 2005–06 financial year in accordance with the current price determination, which expires on 30 June 2008. In the course of approving 2005–06 prices, the ICRC agreed to pass through an adjustment reflecting the impact of the stage three water restrictions in the ACT in the period to December 2003. This adjustment also included an amount for extra bushfire and drought recovery expenses incurred by ACTEW and previously unforeseen. For future years in the current four-year price determination, similar

adjustments will be made in arrears on application for those periods in a year where stage three or higher restrictions occurred. Adjustments will not be made in years where there are less than stage three restrictions. The pass through recognises the artificial restraint on revenue recovery as a consequence of the application of government policy, compared to uncertainties in the market, which the supplier would normally have to bear in an unconstrained commercial environment.

Transport

Annual price resets

The ICRC agreed to annual price resets for both taxi and public bus services (ACTION) for the 2005–06 financial year. Taxi prices were adjusted for the first time by reference to a new indexation approach adopted in 2004. ACTION service pricing was adjusted for the third time in the course of the current triennial price path, the adjustment in the first two years was nil and for the latest year adjusted for inflation over the past twelve months as per the ICRC's 2003 price determination.

ACTION pricing 2005–06 to 2008–09

The ICRC expects a reference to be issued by October 2005 for a review of ACTION prices for the period commencing 1 July 2006.

Utilities Act issues

Compliance reporting

The ICRC is preparing for its compliance reporting process, with returns from licencees due October 2005. This year compliance reports for networks and retail suppliers using standards set in the *Utilities Act 2000* will be augmented by reports against greenhouse gas abatement standards.

The ICRC issued its 2003–04 compliance report in March 2005 and expects the 2003–04 performance report to be released in September 2005. The compliance report for 2004–05 is expected by December 2005.

Compliance audit framework paper

The ICRC issued its discussion paper on a proposed compliance audit framework in June 2005. The ICRC will release its draft report for consultation following the August ICRC's meeting. The framework will provide guidance on the ICRC's approach to auditing data reported in the annual compliance auditing process. The ICRC will issue an audit program consistent with the framework later in the year and commence audits where necessary in 2006.

Greenhouse gas abatement benchmarks

The ACT greenhouse gas abatement scheme commenced on 1 January 2005 with the introduction of the *Electricity (Greenhouse Gas Emissions) Act 2004*. The ICRC is required to set benchmarks for 2006 by the end of November 2005. Reports on performance against the benchmarks will be received later in the year.

Tasmania

Office of the Tasmanian Energy Regulator (OTTER)

Review of the Tasmanian Electricity Code

Tasmania became a participating jurisdiction in the National Electricity Market (NEM) on 29 May 2005. The Tasmanian Electricity Code (TEC) was revised in recognition of the application of National Electricity Law (NEL) from that date.

The substantial review of the TEC reflects the transfer of certain responsibilities to NEM institutions. The revised TEC takes account of NEL and deletes certain chapters and clauses which would otherwise be inconsistent with NEL. The revised TEC also gives effect to amendments aligning with current and established best practice in technical matters and administrative procedure.

The revised TEC is available from the regulator's website at www.energyregulator.tas.gov.au.

Incident reporting guideline

The regulator has issued a guideline on incident reporting for the Tasmanian electricity supply industry.

The revision of the TEC necessitated a review of some aspects of the existing investigation and reporting arrangements for significant incidents. It was also an opportunity to undertake a wider review of arrangements.

The review considered:

- incident reporting arrangements in the NEM—and their contribution to Tasmanian interests
- additional provisions that might be necessary/ appropriate for Tasmania
- experience from the existing reporting scheme in Tasmania, including its scope, timeliness of outcomes, implementation of learning from the reporting, monitoring of implementation of agreed actions
- the performance outcomes from the scheme.



As part of the review and to give effect to the relevant amended TEC provision, the regulator developed an Incident Reporting Guideline with assistance from key stakeholders.

The guideline gives effect to the revised TEC. It recognises and complements the National Electricity Code incident investigation arrangements.

The guideline and the statement of reasons are available on the regulator's website at www.energyregulator.tas.gov.au.

Approval of Hydro Tasmania's Storage Data Report

The regulator has approved the form of reporting headwater storage data by Hydro Tasmania.

Hydro Tasmania is required under the Electricity Supply Industry Amendment Regulations 2004 to publish data relating to its energy production capability on its website on a weekly basis.

Under the relevant regulations Hydro Tasmania is required to report:

- the amount of energy in storage in each headwater storage (expressed both in gigawatt hours and as a percentage of maximum storage capacity) at a fixed time of the week determined by Hydro Tasmania
- whether, in the 24 hour-period immediately before the measurement time, the amount of energy in storage in each headwater storage rose, fell or remained static
- the power stations that utilise the water from each headwater storage.

Hydro Tasmania publishes the following headwater storage data reports on its website:

- Current Storage Report (in schematic format)
- Historical Storage Data Report (in table format and includes the raw data on which the Current Storage Report is based).

After reviewing the two headwater storage data reports and considering submissions from interested parties, the regulator approved the form of the two reports. The statement of reasons for the approval is available from the regulator's website at www.energyregulator.tas.gov.au.

Tasmanian annual planning statement draft guideline

Tasmania became a participating jurisdiction in the NEM from 29 May 2005 which gave effect to National Electricity Law and the National Electricity Code (NEC). As part of the NEM, Tasmania has the benefit of NEM institutions, including power system planning as provided for in the NEC.

The level of aggregated information provided by NEM planning documentation does not address intra-regional constraints (unless they significantly affect inter-regional power flows) and does not go down to the level of terminal sub-stations and other aspects of the power system which have a more immediate impact on customers, distributors and retailers. In order to address this information deficiency, Transend is required by its transmission licence to publish an annual planning statement.

The regulator has issued a draft guideline that is intended to ensure that the scope of the Tasmanian annual planning statement is matched to its purposes and the level of detail is sufficient to meet reasonable stakeholder needs. The regulator is presently seeking comment in respect of the proposed guideline.

Appointment of members to the reliability and network planning panel

The regulator has appointed eight members to the Tasmania's reliability and network planning panel (RNPP) for a period of three years from 1 June 2005. In establishing the membership of the panel, the regulator sought to establish a balance of:

- technical skills from within the industry
- technical judgment from practitioners, not necessarily from the electricity industry but with an appreciation of the decision-making systems relevant to the tasks of the panel
- representation of those with an interest in the reliability of the power system.

The RNPP is chaired by the Director, Energy Planning.

Power system reliability—2004 review

The RNPP completed its 2004 review of the reliability of the Tasmanian power system in April 2005.

The RNPP concluded in its report that there had been a significant decrease in overall power system reliability over the previous year. Significant issues that remain to be addressed include the improvement of the security of the transmission system.

The report also concluded that the medium term outlook is for continuing improvement in power system reliability performance, subject to the vagaries of the weather and the effects of doing transmission augmentation work. Customers can generally be confident of the continuation of a satisfactory level of reliability performance for the Tasmanian power system in the medium term.

The final report is available on the regulator's website at www.energyregulator.tas.gov.au.

Jurisdictional transmission planning criteria

The regulator issued terms of reference for the RNPP to develop jurisdictional transmission planning criteria. The RNPP expects to publish an issues paper at the end of August 2005, which will propose transmission planning criteria for Tasmania and seek comment from licensees and interested parties.

The RNPP expects to finalise the criteria and recommend these to the regulator in a final report in January 2006.

Reviews of frequency operating standards and capacity reserve standards

The Tasmanian Electricity Code requires the RNPP to review the Tasmanian power system security and reliability standards, annually, until the interconnection date (the date on which Basslink enters into commercial operation). The RNPP is also required to annually review the frequency operating standards for Tasmania until 29 May 2007.

Accordingly, the RNPP expects to commence its 2005 review of the frequency operating standards and the capacity reserve standards in July 2005.

Revised accounting ring fencing guideline

Since 1999 Aurora Energy Pty Ltd (Aurora) has been required to comply with Accounting Ringfencing Guidelines issued under chapter 11 of the Tasmanian Electricity Code (TEC). With Tasmania becoming a participating jurisdiction in the NEM, Part G of chapter 6 of the NEC now applies in respect of distribution services and requires the jurisdictional regulator to issue ringfencing guidelines for distribution services.

On 26 May 2005 the regulator issued a revised *Electricity Distribution and Retail Accounting Ring Fencing Guideline* that details his requirements for the accounting separation of distribution and retail services. The guideline also applies to the retail functions of Aurora, as the regulator is responsible for determining maximum prices for retail tariffs for franchised tariff customers.

The information collected by the regulator pursuant to this guideline will include information compiled in accordance with the National Regulatory Reporting Requirements as set out in the Utility Regulators Forum discussion paper *National Regulatory Reporting for Electricity Distribution and Retailing Business* March 2002.



The electricity price determination 2003 made provision for the adjustment of regulated distribution services revenues to take account of actual approved capital expenditures and the pass through of certain other costs over the period of the determination. Similarly, regulated tariffs may be adjusted to take account of certain pass through cost items. The regulatory accounting statements will provide the regulator with audited actual financial data by which to verify the actual costs taken into account in adjusting revenues and tariffs submitted as part of the annual compliance statement.

The guideline is available on the electricity guidelines page of the regulator's website www.energyregulator.tas.gov.au.

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Queensland

Queensland Competition Authority —QCA

Electricity

The QCA released its final determination on the regulation of electricity distribution in April 2005. The draft determination sets out the regulatory arrangements to apply to Queensland's electricity distribution network service providers (DNSPs), Energex and Ergon Energy, for the five-year period commencing on 1 July 2005.

The QCA prepared its final determination in accordance with the requirements of the National Electricity Code. In doing so, the QCA considered submissions from the DNSPs and other interested parties. The QCA also relied on data supplied by the distributors and on analysis undertaken by a number of independent consultants with specialist skills in various areas. The final determination and consultants' reports can be downloaded from the QCA's website at www.qca.org.au.

The final determination includes a revenue cap form of regulation based on a cost building block approach.

Of the proposed building blocks:

- new asset valuations were completed for the DNSPs resulting in regulatory asset bases of \$4.3 billion for Energex and \$4.2 billion for Ergon Energy at 1 July 2005
- the DNSPs' capital expenditure requirements, in real terms, were assessed by the QCA's consultants to be \$2.7 billion for Energex and \$2.8 billion for Ergon Energy

- the QCA adopted a post-tax weighted average cost of capital of 8.5 per cent
- a straight line method of depreciation was continued to reflect the consumption of assets over time
- the QCA's consultants assessed Energex's operating expenditure requirements at \$1.3 billion and Ergon Energy's at \$1.2 billion, in real terms, over the five-year regulatory period.

The final determination included a number of new measures proposed in response to the findings of the independent panel appointed by the Queensland Government to review electricity distribution and service delivery into the 21st century (July 2004). The QCA noted that some of these measures should not be seen as creating a precedent for future regulatory decisions.

The final determination reduced allowable revenue by \$46 million for Energex and \$65 million for Ergon Energy in the next regulatory period to reflect the extension of overall lives for a number of assets in the new asset valuations and the associated writing back of depreciation that had previously been received by the distributors.

The electricity distribution and service delivery review was critical of Energex's service quality performance and failure to undertake necessary operating and maintenance expenditure. Energex had consistently under-spent on opex relative to its forecast requirements at the start of the current regulatory period by around \$87 million (after adjustment for efficiencies). As much of this past under-spend would have to be spent in catching up on necessary maintenance in the next regulatory period, the QCA deducted this amount from Energex's future allowable revenue. This would avoid customers being required to pay twice for the same work.

Given the uncertainties surrounding peak demand growth and the associated difficulties in forecasting capex and opex requirements, the QCA established demand triggers and capex pass-through mechanisms as part of the regulatory arrangements.

The demand triggers were based on a 3 per cent variation in customer numbers or maximum demand. The activation of a trigger would result in a review of the implications of the change and may lead to a compensating revenue adjustment.

The QCA proposed capex pass-through mechanisms tailored to each DNSP. For Energex this was designed to address the potential for it to demonstrate that its capex requirement exceeded the level reflected in the capex building block. For Ergon these were designed to address the

particular risks faced by Ergon due to uncertainty surrounding the commencement of large projects on its dispersed network. Energex would also benefit from one of these provisions related to large customer impacts.

The QCA also retained a general pass-through mechanism to manage the costs associated with unanticipated major changes in the operating environment of the distributors.

As a result of its decisions on the cost building blocks, the QCA proposed aggregate revenue requirements to be raised from distribution charges over the next regulatory period of \$3.93 billion for Energex and \$3.85 billion for Ergon Energy.

In accepting the independent panel's recommendations, the government had assured franchise customers that their final electricity prices would not rise by more than the CPI as a result of the increased investment needed to restore capacity to the networks. The QCA was therefore particularly concerned with the likely impact on contestable customers, who did not have the benefit of the government's price guarantee. As a result, the QCA set side constraints on future price increases for contestable customers of CPI plus 5 per cent for Ergon Energy's customers and CPI plus 4.5 per cent for Energex's customers.

Given the establishment of minimum service standards by government in response to the Electricity distribution and service delivery review, the QCA delayed the introduction of a service quality incentive mechanism but will continue to monitor a range of service quality measures.

Consistent with past practice, the final determination required the distributors to submit pricing principles statements for approval. The QCA then approves annual distribution prices that have been calculated in accordance with those pricing principles statements and which target the allowed annual revenue requirements set in the final determination. The QCA approved the DNSPs' proposed prices for 2005–06 following the release of the final determination.

In the final determination, the QCA noted its concern with the quality of information being reported in the regulatory financial accounts, particularly those of Energex, during the current regulatory period. In essence, the information provided did not allow meaningful comparisons of performance to be made from year-to-year or across the regulatory period relative to forecasts at the start of the regulatory period. To address these concerns, the QCA proposed a revised set of regulatory reporting guidelines which were promulgated in May 2005.



In April 2005 prior to the release of the Final Determination, the QCA approved the DNSPs' proposed distribution loss factors to apply for 2005-06.

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Gas

In May 2005 Allgas and Envestra applied for approval to pass-through costs associated with a number of events that were not foreseen at the time the access arrangements were approved. The items for which cost pass-through were sought included the QCA levy, a distribution authority fee and licence and audit fees associated with the recently introduced *Petroleum and Gas (Production and Safety) Act 2004*. In addition, Allgas applied for pass-through of costs associated with its role of market operator. Subject to some adjustments, the QCA approved the pass-through of these additional costs, which have been included in the revised tariffs for the coming year.

The service providers submitted revised reference tariffs for 2005-06 in May 2005, which the QCA subsequently approved, having determined that the proposed tariff schedules met the price paths and side constraints established in the approved access arrangements.

The approved access arrangements expire on 30 June 2006 and require Allgas and Envestra to submit revised access arrangements to the QCA by 1 October 2005. The QCA is unlikely to release an issues paper prior to receipt of the revised access arrangements.

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Ports

Draft access undertaking

The Dalrymple Bay Coal Terminal (DBCT) is owned by the Queensland Government but has been leased to the Prime Infrastructure Group (DBCT Management). As part of the leasing process, the DBCT was declared for the purposes of third party access under the QCA Act.

The QCA released its final decision on 20 April 2005. In finalising its decision, the QCA considered a range of issues where both the terminal lessee and terminal users often had diametrically opposed views, including in relation to capital expansion, price, cost of capital and asset values. The QCA's decision in relation to DBCT provides for:

- weighted average cost of capital of 9.02 per cent

- return on equity of 11.84 per cent which is 600 basis points above the risk free rate
- price of \$1.72 per tonne until further expansion occurs.

In its decision, the QCA also set out a framework for approving capacity expansions at the terminal. This was necessary as DBCT management chose not to include an upfront capital expenditure program to underpin future capacity expansions at the terminal as part of its draft access undertaking submission to the QCA. DBCT Management has only recently completed work on its proposed expansion path for the terminal.

The above matters remove any potential regulatory road blocks to the expansion of the DBCT.

In resolving these issues, the QCA's final decision identifies all of the changes that need to be made to the draft access undertaking so that a complying undertaking may be lodged and approved.

To date, Prime has not resubmitted a draft access undertaking.

Price review arbitration

The access undertaking only applies to access negotiations entered into after the undertaking is approved and will not apply to existing user agreements.

The existing user agreements do provide for a price renegotiation. Following the breakdown of the price negotiations between DBCT Management and users in early 2004, disputes under each of the current user agreements were subsequently referred to the QCA for arbitration. On 10 June 2004 an arbitration protocol was executed by all parties governing the conduct of the arbitration. On 13 August 2004 the QCA issued an interim award on the scope of the dispute.

Since that time, and in accordance with the agreed arbitration protocol, the QCA has taken no further steps in the arbitration. Many of the matters in the arbitration are similar to the pricing matters in the access undertaking.

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Local government

On 10 March 2005 the QCA commenced a review of progress in implementing competition reforms by Queensland's 125 councils concerning 731 nominated business activities and 110 COAG water activities. This review covers competition reforms implemented as at 30 June 2005.

An integral component of this review is the formulation of recommendations about the redistribution of unexpended funds from the Local Government Financial Incentive Payments Scheme to those councils that exceeded their NCP implementation requirements.

A report will be submitted to the ministers by 28 February 2006.

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Water

Gladstone Area Water Board—investigation of pricing practices

In April 2004 the premier and the treasurer directed the QCA to undertake an investigation of the pricing practices of the Gladstone Area Water Board (GAWB). The QCA was also directed to investigate the appropriate framework for monitoring pricing practices (including prices and contractual arrangements) relating to the declared activities.

To initiate the review, the QCA released an issues paper in April 2004. In response to the issues paper, the QCA received a number of submissions from stakeholders which were taken into account in preparing a draft report for further consultation in December 2004. Key issues addressed in the draft report included the form of regulation for the next regulatory period (price cap v. revenue cap), the pricing framework, the impact of the revised safe yield of Awoonga Dam and changes in demand by new and existing customers following the 2002-03 drought.

After consideration of issues raised in submissions received in response to the draft report, the QCA's final report of recommendations regarding GAWB's pricing practices was provided to ministers in March 2005. A ministers' decision on the QCA's recommendations is expected by July 2005.

The issues paper, draft report and final report of recommendations are available from the QCA or can be downloaded from the QCA's website at www.qca.org.au. Submissions from stakeholders can also be viewed on the QCA's website.

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| VIC | Essential Services Commission Mr Paul Fearon | www.esc.vic.gov.au (03) 9651 0211 |
| TAS | Govt Prices Oversight Commission (GPOC) Mr Andrew Reeves | www.gpoc.tas.gov.au (03) 6233 5665 |
| | Office of the Tasmanian Energy Regulator (OTTER) Mr Andrew Reeves | www.energyregulator.tas.gov.au (03) 6233 6323 |
| QLD | Queensland Competition Authority (QCA) Mr John Hall | www.qca.org.au (07) 3222 0500 |
| WA | Economic Regulation Authority (ERA) Mr Lyndon Rowe | www.era.wa.gov.au (08) 9213 1900 |
| SA | Essential Services Commission of South Australia (ESCOSA) Mr Pat Walsh | www.escosa.sa.gov.au (08) 8463 4444 |
| ACT | Independent Competition and Regulatory Commission (ICRC) Mr Paul Baxter | www.icrc.act.gov.au (02) 6205 0799 |
| NT | Utilities Commission Mr Alan Tregilgas | www.utilicom.nt.gov.au (08) 8999 5480 |
| NZ | Commerce Commission Mr Geoff Thorn | www.comcom.govt.nz +64 4 924 3620 |