

**Contents**

<b>Performance indicators and price monitoring: assessing market power</b>	<b>1</b>	<b>National developments</b>	<b>10</b>	Western Australia	19
<b>Market power and performance indicators</b>	<b>1</b>	Communications	10	Australian Capital Territory	22
<b>Performance indicators and price monitoring: assessing market power: a response</b>	<b>7</b>	Transport and Prices Oversight	13	New South Wales	23
<b>Can we measure 'profit' in the presence of sunk costs?</b>	<b>7</b>	Australian Energy Regulator	13	Tasmania	25
		<b>State developments</b>	<b>16</b>	Queensland	26
		Victoria	16	Northern Territory	27
		South Australia	17	Contacts	28



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## Performance indicators and price monitoring: assessing market power

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In many Australian jurisdictions, companies providing services such as rail, ports management and interstate gas transportation are subjected to 'light handed' regulation using a price monitoring framework. Under this approach, a company can set its own prices freely, but the jurisdictional regulator would monitor those prices with an eye towards achieving social objectives such as promoting economic efficiency, enhancing competition and preventing the misuse of market power. Under a price monitoring regime, regulators can therefore be called on to make assessments of a company's market power and to impose regulatory sanctions if there has been a substantial misuse of that power.

Some regulators are interested in using performance indicators to aid in market power evaluations. Potential performance indicators include company prices and profits, trends in a company's total factor productivity (TFP) and the quality of regulated services provided to customers. However, some indicators can be 'noisy' due to random or otherwise unpredictable factors that affect of these measured performances. Some indicators may also conflict or have different implications regarding firms' potential exercise of market power.

This paper is designed to help regulators evaluate whether firms subject to price monitoring regimes are exercising substantial market power. A conceptual framework for evaluating this issue is developed using information on changes in the values of selected indexes of performance. This conceptual framework bears some similarities to previous work (especially papers by Waters and Street (1998) and Salerian (2003)) that shows how indicators developed using indexing methods can be used to monitor and analyze firm performance.<sup>1</sup> The current paper shows how performance indexes can also be used to analyze market power issues. We conclude that some directional changes in these indicators may in fact be indicative of market power abuse, and signal a need for greater regulatory investigation, while others do not.

1 See Waters, W G and Street, J (1998), 'Monitoring the Performance of Government Trading Enterprises', *The Australian Economic Review*, vol. 31, no. 4, pp. 357-71 and Salerian, J (2003), 'Analysing the Performance of Firms Using a Decomposable Ideal Index Number to Link Profit, Prices and Productivity', *The Australian Economic Review*, vol. 36, no. 2, pp. 143-55.

### Market power and performance indicators

A firm is conventionally said to exercise market power when it raises its price by restricting its output. Customers will be worse off, since they are now paying more and purchasing less than before market power was exercised. A salient consequence of a company's use of market power is therefore that a company increases its own welfare (i.e. raises its profits) at the expense of its customers' welfare (i.e. higher prices for and lower consumption of the goods or services in question).

Firms can also exercise market power by diminishing the quality of service they provide to customers. In effect, quality reductions are tantamount, and logically equivalent, to an increase in price. Whether customers pay more for a product of a given quality level, or continue to pay the same for a lower quality product, the firm's exercise of market power diminishes customer welfare.

The company itself is also better off, since it avoids the costs that are associated with providing a higher quality product and thereby increases its profits.

There is a relationship between changes in TFP, changes in prices and changes in profits. This is illustrated in the indexing logic presented below. Let an index of the firm's revenue be given by R, an index of output price be given by P, and an index of output quantity be given by Y. Revenue is equal to output price times output quantity, or

$$R = Y * P \tag{1}$$

Taking logs and differentiating, the change in revenue can then be decomposed into the sum of changes in output quantity and output price indexes, or

$$\Delta R = \Delta Y + \Delta P \tag{2}$$

Similarly, let an index of the firm's cost be given by C, an index of prices of inputs



used in production be equal to  $W$ , and an index in the quantity of the inputs used in production be given by  $X$ . Cost is equal to the input price index multiplied by input quantity index or

$$C = W * X \quad (3)$$

The change in cost can be therefore decomposed into the sum of changes in input quantity and input price indexes, or

$$\Delta C = \Delta X + \Delta W \quad (4)$$

Furthermore, define an index of profits as the ratio of a revenue index to a cost index.

$$\pi = R / C \quad (5)$$

The same logic implies that the change in the profit index is equal to the change in the revenue index minus the change in the cost index

$$\Delta R - \Delta C = \Delta \pi \quad (6)$$

Substituting (2) and (4) into (6) yields

$$\Delta Y + \Delta P - (\Delta X + \Delta W) = \Delta \pi \quad (7)$$

Re-arranging (7) we have

$$\Delta P = \Delta W - (\Delta Y - \Delta X) + \Delta \pi \quad (8)$$

TFP change ( $\Delta TFP$ ) is defined as the change in output quantity minus the change in input quantity.

Therefore (8) is equivalent to

$$\Delta P = \Delta W - \Delta TFP + \Delta \pi \quad (9)$$

This equation shows that there is a relationship between measures of customer welfare (prices), measures of company welfare (profits), and changes in TFP. If TFP (and input prices) do not change, then there is an inverse relationship between customer and company welfare: increases in profit indexes are associated with increases in price indexes, which all else equal decrease customer welfare. However, this is not necessarily true when TFP increases. TFP growth can enable profits to increase at the same time that prices decline.

The indexing logic is more complicated if quality is introduced into the analysis, but the basic conclusion is the same. If prices are unchanged and quality declines, this is tantamount to a price increase. Similarly, if prices are unchanged and quality increases, the prices that the customer pays for the product have effectively been reduced.<sup>1</sup>

Hence TFP growth can also be manifested in quality improvements for customers at the same time that company profits increase.

More generally, these equations show that the growth, or decline, in a firm's TFP can be reflected in some combination of changes in its prices, profits, or the quality of service provided to its customers.<sup>2</sup> TFP gains are 'distributed' as price reductions, profit increases or service quality improvements. TFP losses are 'distributed' as price increases, profit declines, or service quality deterioration. The movements in these various performance indicators can help analysts gain a fuller understanding of changes in customer and company welfare and, potentially, market power assessments.

### Using performance indicators to monitor market power

The current framework considers how changes in prices, profits, service quality, and TFP may be associated with movements in a firm's market power. The focus is entirely on how *changes* in performance indicators may or may not be associated with *changes* in potential market power abuse. Analyzing changes rather than levels is a straightforward method for assessing market power concerns. It is also likely to be consistent with how price monitoring regimes actually evaluate market power i.e. in each year a regulator will consider whether new information on performance indicators signals that there has been a significant change in a company's exercise of market power, as compared with the last observed performance indicators and market power assessment.

We assume that the regulators will compute and observe indexes of prices, profits and quality each year.<sup>3</sup> There is no loss in generality in our analysis by assuming that the regulators use a single quality metric rather than multiple metrics. We further assume that the regulators will be calculating the change in TFP for the company in each year.<sup>4</sup>

Given these assumptions, the framework focuses on assessing the extent to which changes in the four performance indicators (prices, profits, quality and TFP) are consistent with increases in a company's potential exercise of market power. As discussed, if market power is being abused, a company must be increasing its welfare at the expense of its customers' welfare. A necessary condition for market power abuse is therefore that customer welfare is declining and company welfare is improving. Customer welfare depends on prices and quality. However, price is considered to be a less 'noisy' signal of customer welfare than quality because measured quality for some regulated services may vary from period to period because of random factors that are beyond the company's control. In any given year, the framework therefore puts more weight on price increases as an indicator of reduced customer welfare than quality decreases. Similarly, in a given year, more weight is placed on price decreases as an indicator of improved customer welfare than quality increases.

The indexing logic also shows that, all else equal, TFP increases are associated with price declines and therefore improving customer welfare. We would therefore expect to see consumer welfare increasing in a year when TFP is increasing compared to a year in which TFP declined. If this is not the case, it is more likely that the company is exercising market power in a way that prevents customer welfare improvements. We therefore believe that contemporaneous decreases in customer welfare and improvements in company welfare will be more indicative of market power abuses if those movements take place when TFP is increasing rather than if TFP is decreasing.

1 These notions are sometimes formalised in 'hedonic' analyses, where economists quantify the payments that customers implicitly make for different attributes of products. Higher prices in the marketplace are associated with 'more' of a given attribute. For example, automobile prices embody implicit payments for quality attributes such as headroom, legroom, trunk space, safety, handling, etc. A Cadillac has 'more' of these positive attributes than a Ford Focus and therefore commands a higher price. The US Bureau of Labor Statistics uses hedonic analyses to adjust consumer price changes for some products, like personal computers, whose quality levels are increasing rapidly over time. Thus while a 'raw' comparison of a PC prices in 2006 to those in 1996 would likely indicate a price decline, a 'hedonic' price comparison that controls for quality changes would indicate a much greater price decline. The reason is that not only is the amount paid for a single PC in 2006 less than in 1996, but the PC purchased at a later date is a much higher quality product so the customer gets 'more' PC for the money. This illustrates how quality increases can also effectively be interpreted as price declines.

2 This analysis assumes that factor prices are exogenous; if this is not the case, TFP gains can also be distributed as higher payments for factors of production e.g. labor hired by the firm. This could, in turn, be interpreted as a further division of profit within the firm (or profit sharing) between labor and owners of capital.

3 Although there are many challenges in measuring quality, these issues go beyond the present paper. For the purposes of this analysis, it is more tractable to assume that the regulators have arrived at an overall quality evaluation and/or metric which it uses in market power judgments.

4 It is also assumed that the company is earning 'normal' profits in the preceding year. 'Normal' profits are here defined as a rate of return broadly consistent with the company's opportunity cost of capital. If this assumption is not true, it is not possible to make unambiguous market power assessments using changes in performance indicators. For example, if a firm was earning less than its opportunity cost of capital in the previous year, one has less confidence in concluding that simultaneous increases in profits and prices and reductions in service quality are indicative of market power abuses. The reason is a company may need to raise prices just to attain a 'normal' level of returns rather than the above average returns it would earn if the company was, in fact, exercising market power.



## Analysis and interpretation of scenarios

There are 16 possible scenarios associated with the observed and/or computed performance indicators, which are outlined in Table 1. The first column in this table refers to the specific scenarios. The next four columns give the values for the four performance indicators: TFP, price, quality and profits. A '+' or '-' symbol appears for each of these indicators in a given scenario. A '+' sign indicates that the most recent value for this particular metric has increased, compared with the last observed value for this indicator. A '-' sign indicates that the most recent value for this particular metric has decreased, compared with the last observed value. For example, scenario 1 would occur if, in a given year, a company's measured TFP increased, its price declined, the quality of its services increased, and its profits increased. The 16 scenarios detailed on this table correspond to all possible combinations of the four performance indicators.

The next two columns show the changes in customer welfare and company welfare, respectively, associated with a scenario. In addition to the '+' and '-' signs of the other columns, a '?' symbol appears in the customer welfare column in some scenarios. This symbol indicates that the impact on customer welfare in this scenario is ambiguous. The reason is that there are two indicators of customer welfare—prices and quality—which can move in directions that have conflicting implications for overall customer welfare. For example, if prices go up but quality also increases, it is not clear whether customers are worse or better off. The net impact depends on customers' willingness to pay (WTP) for improved quality relative to the price increases. If WTP is greater than price increases (i.e. than the actual change in what customers did pay), then customers are better off, because they valued the marginal quality improvements by more than their incremental payments for superior quality. However, customers are worse off if the WTP is less than the price increases, because they have now paid more for improved quality than their own valuations of those quality improvements.

Similarly, if prices decline but quality also declines, it is not clear whether customers are worse or better off. The net impact depends on customers' willingness to accept (WTA) quality deteriorations relative to the price decreases they experienced. If WTA is less than price decreases (i.e. than the actual decline in what customers did pay), then customers are better off, because their implicit compensation (via price reductions) for worse quality was more than what the customers would have willingly accepted as compensation for inferior service.

However, customers are worse off if the WTA is greater than the price declines, because the price reductions in this case would not fully compensate customers for how much they valued the quality that was lost.

The final column in Table 1 presents the assessment of whether the observed performance indicators in each scenario are consistent with an abuse of market power. A brief summary of our assessments is as follows:

- In ten scenarios (scenario numbers 1, 3, 4, 7, 8, 9, 11, 12, 15 and 16), we conclude that it is unlikely or impossible for a company to have abused its market power.
- In two scenarios (scenario numbers 6 and 14), it is likely that the company is abusing its market power.
- In one scenario (scenario number 5), it is possible that the company is abusing its market power.
- Three scenarios are ambiguous. In two cases (numbers 2 and 10), the ambiguity depends on customer valuations of service quality (either WTP for quality improvements or WTA quality declines) relative to the price changes that were experienced. In the other case (scenario 13), the ambiguity also depends on the relationship between customers' service quality valuations and price, plus the fact that TFP is declining at the same time that quality is increasing. This could represent a short-term phenomenon where the firm's productivity is temporarily depressed because of capital investments that it is undertaking to improve quality; measured quality is in fact improving in this scenario, and this may benefit customers in the longer term.

Table 2 presents further details on our reasoning behind these conclusions. While the table is fairly self explanatory, in general, we do not find evidence of market power abuse unless there a shift in welfare from customers to companies. Market power abuses are also likely to be more severe if customer welfare is declining while TFP is increasing because, all else equal, TFP gains should be associated with improved customer well-being. Table 2 also shows that further information can be gleaned from some of the 'No' market power abuse scenarios. For example, two scenarios (numbers 8 and 9) are logically impossible. If they occur in practice, this would be indicative of errors in the way data were collected or the way in which the price, quality, profit or TFP indexes were computed. One scenario (number 16) would not be indicative of market power abuse *per se*, but could signal internal financial difficulties at the regulated firm and may therefore still warrant regulators' attention.

## Overview of results

The results are summarized on Table 3, which groups the scenarios into levels of concern for the regulator. Concern level 1 is associated with the two scenarios where market power abuse is likely. Of these two scenarios, we believe scenario 14 is the most troubling and would warrant the greatest regulatory scrutiny. In this case, the firm is improving its welfare at the expense of customers at the same time that its productivity is declining. None of the firm's welfare gains could therefore have been 'distributed' from its greater productivity but must have come entirely at the expense of customers. This is not the case in the scenario 6, where the firm is increasing its TFP and, consequently, at least part of its welfare gains may reflect the distribution of TFP gains to shareholders.

Concern level 2 reflects the one scenario where there is a possible exercise of market power. Concern level 3 is associated with the scenario where the company may be experiencing internal financial difficulties. Concern level 4 is associated with the three scenarios that are ambiguous and depend on customers' WTP for higher prices for service quality improvements or WTA price declines to compensate for quality deterioration. Concern level 5 is associated with the seven scenarios where market power abuse is unlikely. Finally, two scenarios are logically impossible; if these scenarios are in fact observed under the price monitoring regime, they indicate problems either with the data that are being collected or computation of the relevant performance indexes. This is a concern of a different character than that associated with the company's potential abuse of market power and therefore is not ranked on the same scale as the other scenarios.



## Conclusion

This paper presents a simple but hopefully useful analytical framework and diagnostic tool for assessing whether a company's behavior is consistent with a substantial exercise of market power. The approach was to look at the changes in four indexes of company performance—prices, quality, profits and TFP—relative to their values in the previous year. This simplified approach can translate the complexities of company behavior into 16 identifiable scenarios which can be assessed using the grids developed in this paper. While simplified, this approach is likely to be consistent with how many regulators overseeing price monitoring regimes actually monitor market power i.e. in each year, a regulator will consider whether new information on performance indicators signals that there has been a significant

change in the company's exercise of market power, as compared with the last observed performance indicators and market power assessment.

However, the grid-based assessments presented here should not be the basis for the regulator's final evaluation. One reason is that many of these performance indicators will vary from year to year. For example, quality can fluctuate because of random factors beyond management control. TFP can also vary depending on the timing of investments or changes in economic conditions that affect the demand for regulated services. The regulator will therefore be on more solid ground in determining that the company is engaging in an abuse of its market power if it exhibits a pattern of behavior, manifested over more than a single year that is consistent with the scenarios of greatest concern.

In addition, the regulators may find it necessary to examine the levels of profits, price changes, quality changes and TFP growth to see whether any given market behavior qualifies as 'substantial.' Assessments of substantiality involve considerations of both the magnitude and the direction of a set of changes in performance indicators. Making these assessments is ultimately likely to involve a degree of judgment that could differ on a case by case basis. Nevertheless, the tool developed in this paper is intended to be a screening device that helps regulators determine whether a given scenario deserves greater regulatory attention and evaluation of these details.

**Table 1: Performance indicators and market power assessment: evaluation of specific scenarios**

Scenario	TFP	Price	Quality	Profit	Customer welfare	Company welfare	Market power abuse?
1	+	-	+	+	+	+	No
2	+	-	-	+	?	+	?
3	+	-	+	-	+	-	No
4	+	-	-	-	?	-	No
5	+	+	+	+	?	+	Probably yes
6	+	+	-	+	-	+	Yes
7	+	+	+	-	?	-	No
8	+	+	-	-	-	-	No
9	-	-	+	+	+	+	No
10	-	-	-	+	?	+	?
11	-	-	+	-	+	-	No
12	-	-	-	-	?	-	No
13	-	+	+	+	?	+	?
14	-	+	-	+	-	+	Yes
15	-	+	+	-	?	-	No
16	-	+	-	-	-	-	No



**Table 2: Interpretation of scenarios**

Scenario number	Interpretation
1	The 'everyone gains' scenario; TFP is increasing and is being simultaneously 'distributed' as price cuts and improved quality for customers and higher profits for the company.
2	<p>TFP is increasing and the company is benefiting from higher profits; the impact on customers is ambiguous because while prices are falling, service quality is also falling. If service quality is measured without error, and is not being reduced because of exogenous, temporary factors beyond management control, then customer welfare will depend on the customers' valuation of the service quality they have lost relative to the decline in their prices. If the value that customers place on their willingness to accept (WTA) quality deteriorations is less than the decline in prices, then customers have been more than compensated for the decline in quality and are better off. However, if customers' WTA is more than the decline in prices, then customers have not been fully compensated for the decline in quality and are worse off.</p> <p>However, even if customers are worse off under this scenario, one mitigating factor is that measured quality is likely to be a noisier signal of customer welfare than price. Before concluding that there has been a significant misuse of market power, the regulator should be assured that measured quality did in fact decline because of the company's own actions rather than exogenous factors beyond company control, and that the impact of this quality decline on customer welfare was well in excess of the declines in price.</p>
3	TFP is increasing, but company profits are falling. This is in itself indicative of strong market forces e.g. even though the company is enhancing its TFP, its profits cannot keep pace because market forces are pushing down prices at an even faster rate. This interpretation is strengthened by the fact that company prices are in fact falling at the same time that the quality of service provided to customers is increasing.
4	TFP is increasing but company profits are falling. As in scenario 3, this is indicative of strong market forces. The conclusion from scenario 3 is weakened somewhat by the fact that, here, quality is declining and not improving. However, this is not sufficient to conclude that there has been a serious abuse of market power, because the company is not in fact benefiting from this behavior through higher profits.
5	TFP is increasing and the company is benefiting from higher profits; however, customer prices are also increasing so customers are not benefiting from the TFP gains via price reductions. Measured quality has improved, so the impact on overall customer welfare is ambiguous and depends on customer willingness to pay (WTP) for quality improvements relative to the price increases that have been experienced. But the presumption is that TFP gains should be associated with unambiguous customer gains, which are not present here, so there is a possible exercise of market power that merits further attention.
6	TFP is increasing, the company is benefiting from higher profits, but customer welfare is declining since prices are going up and quality is declining. This represents a clear shift of welfare from customers to the company and a potential market power abuse the regulator should investigate. However, it should be noted that because TFP is increasing, at least part of the gains in company welfare may reflect the 'distribution' of TFP gains to shareholders.
7	TFP is increasing, but company profits are falling. This may be indicative of strong market forces e.g. even though the company is enhancing its TFP, its profits cannot keep pace. However, unlike scenario 3, company prices are increasing and not falling; the quality of service is also increasing. One interpretation of this scenario is that the market is driving a demand for service quality improvements, and the company is responding. The expenditures for service quality would have to be quite significant in this case, since the company is experiencing increasing TFP and increasing its prices, yet its profit rate is falling. Declining profits cannot be indicative of excessive or wasteful spending; this is ruled out by the rising TFP. In any event, there is little concern that the company is exercising market power here, since the company is not able to improve its own welfare through either its pricing or productivity behavior.
8	This scenario is logically impossible. If TFP is increasing, then company and customer welfare cannot both be decreasing at the same time, but that is what occurs here. Prices are increasing, quality is declining, and profits are declining at the same time that the size of the 'pie' is being increased through greater productivity—a logically impossible outcome. If it is in fact observed, then there must be problems with how one or more of the performance indicators are being measured.
9	This scenario is logically impossible. If TFP is decreasing, then company and customer welfare cannot both be increasing at the same time, which is what occurs here. Prices are decreasing, quality is improving, and profits are increasing at the same time that the size of the 'pie' is being shrunk through productivity declines—a logically impossible outcome. If it is in fact observed, then there must be problems with how one or more of the performance indicators are being measured.



10	<p>This scenario is not impossible but is odd. TFP is declining, yet prices are falling and profits are rising at the same time. This can only be possible if there has been a massive decline in the quality of service provided to customers, which is in fact the case here. If service quality is measured without error, and is not being reduced because of exogenous, temporary factors beyond management control, then customer welfare depends on the customers' valuation of the service quality they have lost relative to the decline in their prices. If the value that customers place on their willingness to accept (WTA) quality deteriorations is less than the decline in prices, then customers have been more than compensated for the decline in quality and are better off. However, if customers' WTA is more than the decline in prices, then customers have not been fully compensated for the decline in quality and are worse off.</p> <p>However, even if customers are worse off under this scenario, one mitigating factor is that measured quality is likely to be a noisier signal of customer welfare than price. Before concluding that there has been a significant misuse of market power, the regulator should be assured that measured quality did in fact decline because of the company's own actions rather than exogenous factors beyond company control, and that the impact of this quality decline on customer welfare was well in excess of the declines in price.</p>
11	TFP is decreasing, but company prices are falling and the quality of service provided to customers are both increasing at the same time. The fact that customer welfare is improving at the same time that the company is not expanding the size of the 'pie' of potential gains is indicative that strong market forces are promoting customer benefit. company profits are also falling, which is consistent with the facts that the company is being compelled to reduce its prices at the same time that it is not boosting its productivity.
12	TFP is decreasing, but company prices are falling. As in scenario 11, this is indicative of strong market forces. The conclusion from scenario 11 is weakened somewhat by the fact that, here, quality is declining and not improving. However, this is not sufficient to conclude that there has been a serious abuse of market power, because the company is not in fact benefiting from this behavior through higher profits.
13	TFP is decreasing yet the company is benefiting from higher profits; this occurs since customer prices are also increasing. Measured quality has improved, so the impact on overall customer welfare is ambiguous and depends on customer willingness to pay (WTP) for quality improvements relative to the price increases that have been experienced. While there is some cause for concern because the company's gains are occurring solely because of its price increases and because of its own efforts to boost TFP, it is possible that TFP has been temporarily depressed because of capital investments the company is undertaking to improve quality, which is in fact already increasing as a result. These quality improvements could ultimately improve customer welfare depending on their WTP, so the overall market power assessment is ambiguous.
14	TFP is declining, yet the company is benefiting from higher profits even as customer welfare declines as prices increase and quality deteriorates. This represents a clear shift of welfare from customers to the company—in fact, because TFP is declining, shareholder gains are coming directly at the expense of customers—and a potential market power abuse the regulator should investigate.
15	TFP is declining and company profits are falling as a result. Prices for customers are increasing at the same time, but quality is increasing so the net impact on customer welfare is ambiguous. While it is possible that the company's price increases are attempting to 'recoup' some of the profit declines that result from its declining TFP, there are two mitigating factors that reduce the concern that this represents a serious abuse of market power: 1) the company is not in fact improving its welfare because of its pricing behavior; and 2) service quality is increasing at the same time, so customer welfare may in fact be improving under this scenario.
16	TFP, customer welfare and company welfare are all declining at the same time. This is not a situation of market power <i>per se</i> , since the firm is not increasing its own welfare at the expense of its customers. Nevertheless, it could be a cause for concern and indicative of serious internal difficulties at the company. This is the opposite of scenario 1, where 'everyone loses.' The losses for customers and company result in part from the company's declining TFP performance, and market forces may also be playing a role. A situation where all parties' welfare is declining could merit attention by the regulator.

**Table 3: Overview of scenarios**

Evaluation	Scenario numbers	Level of regulatory concern
Likely market power	14, 6	1
Possible market power	5	2
Internal financial difficulties	16	3
Ambiguous/depends on customer willingness to pay	2, 10, 13	4
Unlikely market power	1, 3, 4, 7, 11, 12, 15	5
Logically impossible	8, 9	Check internal measurements/computation/data collection



# Performance indicators and price monitoring: assessing market power: a response

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As Larry Kaufmann notes in his paper, in some Australian jurisdictions, companies providing certain services are subject to a ‘monitoring’ regime. It appears that the architects of these regimes expect that regulators will monitor market outcomes, make assessments as to those companies’ market power and will ‘impose regulatory sanctions if there has been a substantial misuse of that power’.<sup>1</sup> Larry’s paper proposes a framework for evaluating ‘whether firms subject to price monitoring regimes are exercising substantial market power’.<sup>2</sup> This would be a valuable contribution if Larry’s paper actually achieved that aim.

But does Larry’s paper provide a useful framework for assessing whether or not a firm is exercising substantial market power? Is that even possible? These questions are explored in this short response.

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<sup>1</sup> Kaufmann, Larry, ‘Performance Indicators and Price Monitoring: Assessing Market Power’, (this journal), p. 1.  
<sup>2</sup> Page 1.

## Can we measure ‘profit’ in the presence of sunk costs?

Larry’s paper takes as given that it is possible to measure the ‘profit’ of a firm on an annual basis. Profit is conventionally defined as revenue less ‘cost’.<sup>3</sup> But, is it possible to measure ‘cost’ in the presence of substantial sunk costs?

Most of the industries which are candidates for price regulation—including the industries Larry mentions (rail, ports, gas pipelines)—involve very substantial sunk costs. The presence of sunk costs gives rise to a ‘common cost’ problem between different time periods, in exactly the same way that economies of scope give rise to a ‘common cost’ problem between different services produced by the firm in the same time period.

Economists are quite used to the notion that, in the presence of economies of scope between services A and B, there is no unambiguous answer to the question: How much does it cost to provide service A? The answer to this question could vary between the incremental cost of service A and the stand-alone cost of service A. The question ‘How much does it cost to provide service A?’ is meaningless because it is not correctly framed.

Exactly the same problem arises in the context of sunk costs. Sunk costs are common to all of the years of the life of the sunk asset. In the presence of sunk costs there is no unambiguous answer to the question: How much does it cost to provide services in year X? The answer depends on how much of the sunk cost is allocated to that year of the life of the asset. This amount could vary between the operating costs directly attributable to those services, and the operating cost plus the entire sunk cost of providing those services. As before, the question ‘How much does it cost to provide services in year X?’ is meaningless because it is not correctly framed.

A simple example might make this clearer. Suppose a regulator has the task of monitoring an airport, with a view to preventing the exercise of market power. Let’s suppose that this airport has a one-off sunk construction cost of \$500 million, and (for the sake of argument) no operating or maintenance costs. For simplicity, let’s take the cost of capital (which is also the discount rate) to be zero. The airport has a life of precisely 50 years. Suppose that we are ten years into the life of the asset. We observe that the airport earned revenue equal to \$15 million in the previous year. Is this airport exercising market power? More precisely, is this airport earning ‘abnormal returns’ or ‘supernormal profits’?

The answer is, of course, that we cannot say. Any assessment of the reasonableness of the annual ‘profit’ of the firm requires a comparison between the revenue earned by the firm and the ‘cost’ incurred in that year. But any such cost estimation requires an allocation of a share of the \$500 million sunk cost of the airport to that year. That allocation is inherently arbitrary and, from an economic point of view, completely meaningless.<sup>4</sup> It is not possible to make an assessment whether or not a firm is earning abnormal returns through a comparison of its revenue and ‘costs’ in a single year of the life of the firm.

We might say that a firm has earned abnormal returns if, over its entire life, it earns a revenue stream with a present value greater than the present value of its expenditure stream. Unfortunately, we only know the entire out-turn revenue and expenditure stream over the life of the firm after that firm has ceased to exist. Of course, it is not possible to regulate a firm ‘after the fact’, but viewing the problem in this way reminds us that it *is* possible to make provisional, forward-looking statements of the form: ‘Taking into account the revenue expenditure the firm has earned to date, if this firm continued to earn revenue at the current rate, with no change in its annual expenditures, over its life it would receive a revenue stream with a present value in excess of the present value of its expenditures and therefore

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<sup>3</sup> Larry’s paper defines profit as the ratio of revenue to cost, which introduces its own quirks, but that is not the primary issue I would like to focus on here

<sup>4</sup> More precisely, the only way to allocate these costs in an economically meaningful way is to take into account the impact of any particular allocation on the economic decisions of end-users.



could be said to be exercising market power'. In other words, by forecasting revenue and expenditure into the future we can make provisional statements about whether or not a firm is likely to be exploiting market power. However, such statements based on forecasts of future revenue and expenditure outcomes are inherently speculative.

The point I wish to emphasise is the following. In the presence of sunk costs, it is not possible to unambiguously determine the 'profit' of the firm in any one year. As a consequence, it is not possible to use 'profit' as an indicator of the presence of market power, or as an indicator of anything meaningful at all. The failure to recognise this point is a key error which often is not understood by the architects of 'price monitoring' regimes. Larry's paper perpetuates this misunderstanding.

### Does Larry's paper provide a framework for detecting market power?

Let's now put aside the central objection that it is simply not possible to measure profit in the industries which are of concern. Specifically, let's make the (somewhat heroic) assumption that there are no sunk costs in the industries of concern. Under this assumption, does the framework set out in Larry's paper provide useful criteria for detecting the exercise of market power?

As we will see, the answer is no, primarily due to Larry's unconventional definition of 'market power'.

Larry notes that 'A firm is conventionally said to exercise market power when it raises its price by restricting its output'.<sup>5</sup> However, since (assuming a downward sloping demand) this observation has little empirical content (since any increase in price is associated with a reduction in output), Larry uses an alternative definition that a company is exercising market power if it 'increases its own welfare (i.e. raises its profits) at the expense of its customers' welfare (i.e. higher prices for and lower consumption of the goods or services in question)'.<sup>6</sup>

Is this a sensible definition of market power? A more conventional economic definition is that a firm has market power if it faces a downward sloping demand curve and therefore has the incentive and ability to profitably alter prices away from competitive levels. A conventional indicator of market power is the Lerner index (that is the price—marginal cost margin)  $L = \frac{P-MC}{P}$ . An increase in the Lerner index is conventionally taken as a sign of an increase in market power.<sup>7</sup>

A key problem with Larry's definition is that it makes no reference to a competitive benchmark. Let's imagine a firm which is currently pricing above marginal cost (and therefore is exercising market power by conventional measures). A change in the structure of the costs of this firm might simultaneously raise its marginal cost and lower its fixed cost. This might reduce the price-marginal cost margin—reducing the extent of market power by conventional measures—at the same time as it raises prices and raises profits—which would constitute an abuse of market power by Larry's measure.

Conversely, a change in the structure of costs which reduced marginal cost and raised fixed costs, might widen the price-marginal cost margin (thereby increasing the extent of market power by conventional measures) while simultaneously lowering prices and lowering profits. In this case an increase in market power (by conventional measures) would, by Larry's definition, be classified as harmless. Larry's definition of market power is, in my view, inappropriate.

The central claims in Larry's paper derive from Table 1, in which he links changes in the four indicators (TFP, price, quality and profit) to market power abuse outcomes. The two possible directions of change in each of the four indicators give rise to 16 scenarios. Associated with each of these scenarios is the suggested market power abuse interpretation, which is spelled out in more detail in Table 2.

As an aside, it is interesting to note that the market power abuse outcome (the final column) in Table 1 is virtually entirely independent of whether TFP is increasing or decreasing. That is, the market power abuse outcomes in scenarios 1–8 (in which TFP is increasing) are virtually identical to the market power abuse outcomes in scenarios 9–16 (in which TFP is decreasing). The only difference is between scenarios 5 and 13, in which—when TFP is increasing—the market power abuse interpretation is 'Probably Yes' whereas—when

TFP is decreasing—the market power abuse interpretation is '?'. In other words, according to Table 1, computing the TFP provides virtually no additional information as to the likely presence or absence of a market power abuse, despite the assertion earlier in the paper that:

Contemporaneous decreases in customer welfare and improvements in company welfare will be more indicative of market power abuses if those movements take place when TFP is increasing rather than if TFP is decreasing.<sup>8</sup>

Let's now turn to the market power abuse interpretation given to each of the scenarios in Table 1. These interpretations are at the core of the framework proposed by Larry. However, for the reasons given above, the proposed interpretations do not provide a reliable guide for detecting market power as it is conventionally defined.

The first scenario involves declining price and increasing productivity, quality and profit. Larry interprets this as the 'everyone gains' scenario, which is said to involve no market power abuse (Table 1). Can we have a market power abuse with declining price and increasing productivity and profit? As noted above, an increase in productivity combined with a fall in input prices may well lower marginal cost. If little of this fall in marginal cost is passed on to consumers in the form of lower prices, the price-marginal cost margin (the Lerner index) could well rise at the same time as profit rises. It seems to me that, in contrast to the conclusions of the paper, we cannot be certain that a decline in price and an increase in profit (scenario 1) is evidence of an absence of abuse of market power.

What about a scenario which Larry's analysis identified as highly likely to indicate an abuse of market power? The sixth scenario involves increasing productivity, increasing price, declining quality and increasing profit. Larry observes that this scenario 'represents a clear shift of welfare from customers to the company and a potential market power abuse the regulator should investigate'.<sup>9</sup>

But is it clear that this scenario is a market power abuse? An increase in the price of variable inputs could easily outweigh any increase in productivity, so as to increase the marginal cost of the firm. If this increase in marginal cost is not passed on to consumers, the price-marginal cost margin could well fall. At the same time, a sufficient reduction in the prices of fixed inputs to the firm could induce profit to rise. Although this scenario may be unlikely, we cannot conclude that this scenario results in a clear shift of welfare from customers to the company—instead it could

5 Page 1.  
6 Page 1.

7 A commonly used textbook, *Industrial Organisation*, by Church and Ware, states that the Lerner index 'is a measure of market power since it is increasing in the price distortion between price and marginal cost. It shows that the market power of a firm depends on the elasticity of demand' (p.36).

8 Page 2.  
9 Page 5.





simply reflect a change in the structure of the costs facing the firm, with an increase in variable costs and a decline in fixed costs.

Let's examine one more scenario. Scenario 8 involves increasing productivity, and price, and declining quality and profit. Larry identifies this scenario as logically impossible since 'if TFP is increasing, then company and customer welfare cannot both be decreasing at the same time'. Larry notes that if this outcome is observed 'there must be problems with how one or more of the performance indicators are being measured'. But is this the case? An increase in input prices could easily outweigh the impact of an increase in productivity, leading to an increase in output prices and a reduction in profitability. I do not see this outcome as being logically impossible.

I have not examined every one of Larry's 16 scenarios. However, examination of this selection suggests to me that Larry's framework does not reliably detect the exercise of market power as conventionally defined.

### Towards a test for market power changes

I have argued that Larry's proposed framework is not suitable as an indicator of market power. But might it be possible to take some steps towards developing such an indicator?

As noted above, one possible indicator of market power is the Lerner index. We may write the Lerner index as one minus the reciprocal of the price/marginal cost ratio. Therefore, changes in the price/marginal cost ratio have the same sign as changes in the Lerner index. Let's imagine the simplest possible technology in which  $a$  units of input are needed to produce one unit of output (in this simple world  $1/a$  is a measure of the total factor productivity). If the price of the input good is  $w$  it follows that the marginal cost of one unit of output is  $aw$ . The price/marginal cost ratio is therefore  $\frac{P}{MC} = \frac{P}{aw}$ . This allows us to conclude that changes in the market power index have the same sign as the percentage change in the output prices less the percentage change in the input prices plus the percentage change in the TFP:

$$\Delta L = \Delta\left(\frac{P}{MC}\right) = \Delta P - \Delta w + \Delta TFP$$

This expression is similar to equation (9) in Larry's paper; however, the justification of the expression above is quite different to the justification used by Larry.

This analysis is suggestive that it may be possible to develop at least some indicators of the presence of market power abuse. For example:

- an increase in output prices, coupled with a decline in input prices and/or an increase in productivity is suggestive of an increase in market power
- conversely a decline in output prices, coupled with an increase in input prices and/or a decrease in productivity is suggestive of a decline in market power.

### Conclusion

The ACCC currently has responsibility for monitoring market outcomes in a number of sectors. It would be desirable—if it were possible—to identify simple criteria, based on observed outcomes, which would enable the ACCC to identify instances of abuse of market power. However, any such criteria must not rely on measurement of annualised 'costs' or annual 'profit'—as we have seen, any such measure is arbitrary in the presence of sunk costs.

Larry uses an unconventional definition of market power. This definition allows Larry to ignore the conventional competitive benchmark of marginal cost. As a result, Larry's proposed criteria gives unreliable results when assessed against a more conventional definition of market power.

As suggested above, it may be possible to develop indicators of changes in the price-marginal cost margin, as an indicator of market power. This is a question for future research.

## Communications

### Enforcement work

#### Revocation of Part A competition notice

On 2 March 2007 the ACCC announced its decision to revoke the Part A competition notice issued in relation to Telstra increasing its wholesale line rental prices.

The *Trade Practices Act 1974* specifies that the ACCC may issue a Part A competition notice if it has reason to believe that the carrier or carriage service provider concerned has engaged, or is engaging, in at least one instance of anti-competitive conduct of a kind described in the notice.

In December 2005 Telstra raised the price of its Home Access product, which is an input used by Telstra's wholesale customers to provide line rental and local call services to consumers. The price increase resulted in Telstra's retail prices for the line rental component for the majority of its fixed voice products being below Telstra's wholesale price for line rental.

On 12 April 2006 the ACCC issued a Part A competition notice to Telstra in relation to the increases in the wholesale price for Home Access. The notice came into force on 13 April 2006, allowing the ACCC to begin penalty proceedings and also activating third party rights to seek compensation for the breach of the competition rule.

Although valid for a period of 12 months, earlier revocation of the notice by the ACCC leaves the notice in force until 27 February 2007 (inclusive).

The decision to revoke the notice was taken in light of the changing regulatory circumstances, including the declaration of the wholesale line rental (WLR) service. The decision followed consultation with industry about developments since the service was declared.

In administering the competition notice provisions of the Act, the ACCC's primary objective is stopping and preventing any anti-competitive conduct. The more involved regulatory processes attached to declaration of the service now enable competitive outcomes to be achieved. Consequently, the ACCC does not see a need for the competition notice to remain in force.

### Regulatory work

#### Twelfth and thirteenth Telstra accounting separation reports released

The ACCC has released two imputation testing and non-price terms and conditions reports under the enhanced accounting separation regime for Telstra. The report released on 29 September 2006 presents data for the June 2006 quarter, while the report released on 21 December 2006 presents data for the September 2006 quarter.

The reports present key performance indicators that compare Telstra's customer service performance in meeting certain non-price terms and conditions for its wholesale and retail customers. Key performance indicators for fixed-line telephony and ADSL services are reported.

The reports also present an imputation analysis that compares Telstra's retail prices to the prices of three core telecommunications access services. The three core access services are the local carriage service (LCS), public switched telephone network originating and terminating access (PSTN OTA) services and the unconditioned local loop service (ULLS).

The analysis in the reports is designed to give an indication about whether there is likely to be sufficient margins between Telstra's retail prices and the prices it charges other service providers to use the core services (plus related costs) to allow efficient firms to compete at the retail level. The analysis is not intended to detect all forms of potentially anti-competitive conduct.

#### Key results—June 2006 quarter

- Declining imputed margins for all fixed line voice services, except for fixed-to-mobile calls and residential international calls, which have remained the same.
- Imputed margins have remained negative for services supplied over the unconditioned local loop core service except when the ULLS is used to supply a bundle of ADSL and voice services to business customers.

#### Key results—September 2006 quarter

- Imputed margins for the ULLS improved in the quarter, although they remain negative except when the ULLS is used to supply a bundle of ADSL and voice services to business customers.

#### Seventh Telstra current cost accounting report released

The ACCC issued its seventh current cost accounting report relating to Telstra on 30 November 2006.

The report contains current cost financial information for 'core' telecommunications access services. It constitutes the information that the ACCC is required to make public in respect of current cost accounting under the direction issued by the Minister for Communications, Information Technology and the Arts in June 2003.

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

The report indicates that on a current cost basis, the aggregate values of assets for the core access services are higher than the historical asset valuations.

The information does not represent the forward-looking cost of assets nor is it calculated using a fully or substantially optimised network configuration.

#### Report on Telstra's compliance with its price controls

On 1 November 2006 the ACCC issued its latest assessment of Telstra's compliance with its retail price control arrangements.

The report concerns Telstra's compliance with arrangements that applied for the six months to December 2005. 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 the adequacy of Telstra's compliance with them.

The ACCC is satisfied that Telstra has adequately complied with its price control arrangements.



## Access disputes

The ACCC is vested with powers to arbitrate telecommunications access disputes and make a final binding determination to resolve a dispute. Arbitration hearings are private and the ACCC generally does not make any public comment on disputes except to announce when a dispute has been notified.

Sixteen new access disputes were notified to the ACCC under Part XIC of the Act and one new access dispute was notified under the *Telecommunications Act 1997*.

## Mobile terminating access service

In December 2006 Telstra notified the ACCC of two access disputes relating to the charges and other terms and conditions of mobile terminating access service (MTAS) payable to Optus Mobile and Optus Networks.

Interim determinations were made on 18 December 2006, and on 15 February 2007 the ACCC published the interim determinations, together with statement of reasons for the two access disputes.

## Line sharing service

Six parties notified the ACCC of access disputes relating to charges associated with Telstra's supply of the LSS:

- TPG Internet
- Network Technology
- Primus Telecommunications
- Adam Internet
- Agile
- Amcom.

On 19 January 2007 the ACCC issued reasons supporting interim determinations made in arbitrations for two telecommunications access disputes regarding various charges payable to Telstra for the supply of the LSS.

The interim determinations were made on 21 December 2006 for LSS access disputes between Telstra and Chime Communications and Request Broadband.

On 23 February 2007 the ACCC published further details of the interim determinations outlining the terms to apply on an interim basis to the connection and disconnection of the LSS (either on an ad hoc basis or as part of a managed network migration), and the basis upon which those terms have been specified.

## Unconditioned local loop service

Three parties notified the ACCC of access disputes relating to charges associated with Telstra's supply of the ULLS:

- Adam Internet
- Optus Networks relating to the supply of the ULLS in multi-dwelling units served with a main distribution frame.
- NEC Australia relating to monthly charges.

Five interim determinations were made in arbitrations relating to the monthly charges payable to Telstra for the supply of the ULLS by the following parties:

- Primus Telecommunications
- Optus Networks
- XYZed
- Request Broadband
- PowerTel.

The ACCC published an interim determination for ULLS monthly charges and its associated statement of reasons for an arbitration between Chime Communications Pty Ltd and Telstra.

## Local carriage service

Access disputes relating to various price terms associated with Telstra's supply of the LCS were notified to the ACCC by both Primus Telecommunications and Optus Networks.

On 8 February 2007 the ACCC published an interim determination and accompanying statement of reasons for this dispute.

## Wholesale line rental

Access disputes relating to price for the supply of the WLR from Telstra were notified to the ACCC by both Primus Telecommunications and Optus Networks.

On 8 February the ACCC published an interim determination and accompanying statement of reasons in relation to the Optus dispute.

## Domestic transmission capacity

On 27 March 2007, the ACCC indicated that Netspace had notified an access dispute with Telstra relating to the price for the supply of domestic transmission capacity between Melbourne and Hobart.

## Access to telecommunications towers

On 5 September 2006 the ACCC indicated that Telstra had notified an access dispute under the Telecommunications Act. The dispute relates to the price paid by Optus Networks for access to

telecommunications towers owned and operated by Telstra and sites of such towers.

## Access undertakings

Under s. 152BS of the Act, a carrier or carriage service provider may provide the ACCC with a written access undertaking under which the carrier or carriage service provider undertakes to comply with the terms and conditions specified in the undertaking in relation to the standard access obligations applicable to that provider. The consideration of an undertaking does not preclude the ACCC from conducting an arbitration, if required, and issuing an interim determination while it completes the undertaking process.

## Fixed line access undertakings

### *Telstra's undertakings for fixed interconnection and local call resale services*

On 29 November 2006 the ACCC issued its final decision to reject Telstra's undertakings for fixed interconnection (PSTN) and LCS.

Telstra's proposed undertaking prices involved a substantial reduction in the headline local call resale prices and a substantial increase in the headline fixed interconnection prices.

The ACCC rejected Telstra's proposed prices on the basis that the charges were not reasonable. Telstra's proposed pricing approach for the fixed interconnection and the local call resale services would represent a fundamental shift in the competitive dynamics in the fixed line service markets. The proposed pricing would also significantly disadvantage facilities-based access seekers.

### *Optus DGTAS undertaking*

On 7 March 2007 the ACCC issued a discussion paper on an access undertaking lodged by Optus Networks Pty Ltd in relation to its domestic GSM terminating access services (DGTAS).

Optus lodged an undertaking with the ACCC for DGTAS on 16 February 2007, specifying certain terms and conditions upon which Optus undertakes to supply the DGTAS.

Under the Act the ACCC must accept or reject an undertaking based on whether it considers the terms and conditions to be reasonable.



## Special access undertakings

### **Foxtel's special access undertaking for digital pay-TV set-top unit service**

On 16 March 2007 the ACCC announced its decision to accept a special access undertaking from Foxtel for its digital pay-TV set-top unit service.

Foxtel lodged its new special access undertaking on 1 December 2006, replacing a special access undertaking previously lodged with the ACCC in October 2005.

The ACCC issued a draft decision to reject the original special access undertaking on 1 September 2006. The ACCC had not reached a final decision before Foxtel withdrew its original special access undertaking. Foxtel made various changes to the price and non-price terms and conditions of access to its digital set-top units to address the ACCC's concerns on the original undertaking.

The new undertaking will permit independent providers of digital content channels—including interactive digital channels—to offer their channels directly to Foxtel customers through Foxtel's digital set-top units. Digital content providers using the undertaking will be able to offer their channels to Foxtel's customers as a tier to Foxtel's Basic Package.

### **Australian Competition Tribunal decision on Optus' MTAS undertaking**

On 22 November 2006 the Australian Competition Tribunal handed down its decision to reject Optus' proposed undertaking for the supply of its domestic GSM terminating access service.

Optus had sought a decision from the Australian Competition Tribunal to overturn an ACCC decision that the terms and conditions on which Optus proposed to supply the service were unreasonable and that the access undertaking should be rejected.

The Australian Competition Tribunal's decision to affirm the ACCC's decision and reject the access undertaking means that the access undertaking will not come into operation and the price specified in it will not become legally binding.

### **Australian Competition Tribunal decision on Vodafone's MTAS undertaking**

On 11 January 2007 the Australian Competition Tribunal handed down its decision to reject Vodafone's proposed undertaking for the supply of its domestic GSM terminating access service.

This decision affirmed the ACCC's decision to reject Vodafone's access undertaking.

The Australian Competition Tribunal was not satisfied that:

- Vodafone's costs were efficiently incurred
- the costs produced in the model prepared for Vodafone by its consultants generated an accurate cost of providing the MTAS
- Vodafone's proposed prices would do no more than cover Vodafone's costs of supplying the service.

The Australian Competition Tribunal's decision to affirm the ACCC's decision and reject the access undertaking means that the access undertaking will not come into operation and the price specified in it will not become legally binding.

### **Pricing principles and draft indicative prices**

On 29 November 2006 the ACCC issued its final determination on pricing principles for PSTN interconnection, LCS and WLR. The ACCC also issued indicative prices for all three services.

Consistent with the draft determination issued by the ACCC on 28 July 2006, the ACCC has determined a cost-based, total service long-run incremental cost + (TSLRIC +) approach to pricing of the fixed interconnection, and maintained a retail minus, retail cost approach for the LCS and WLR.

The indicative access prices set out in a determination are non-binding on parties to arbitrations or undertaking assessments.

The purpose of the determination is to provide guidance to industry on prices that are likely to guide the ACCC when considering an access dispute for these services.

The ACCC considers that any indicative prices relating to the pricing of LCS and WLR for 2006–07 will be transitional in nature. They will stay in place while the ACCC undertakes more detailed analysis on assessing efficient LCS and WLR costs and prices using appropriate costing models.

### **The ACCC seeks submissions on MTAS cost model**

On 1 February 2007 the ACCC released the report *Mobile Termination Cost Model for Australia*, a discussion paper and a reference document calling for submissions regarding its decision to use a WIK-developed model for its future costing of MTAS.

In June 2006 the ACCC engaged WIK-Consult to develop a bottom-up cost model that estimates the efficient cost of supply of the MTAS in Australia using a TSLRIC conceptual framework.

## The ACCC seeks tenders for a fixed network services cost model

In February 2007 the ACCC sought tenders for the development of a fixed network services cost model to inform its regulatory decisions in the future. The ACCC has always been open to considering reasonable cost models developed by industry, but the continuing inadequacy of industry's models has led to the decision that the ACCC needs to have its own cost models.

The successful model would assist the ACCC in its decision making on all regulated fixed services such as the ULLS, PSTN OTA services, LSS and LCS.

### **Revocation of declaration of the analogue pay-TV service**

On 16 March 2007 the ACCC announced its decision to revoke its declaration of the analogue pay-TV service. This follows public consultation and the issuing of a discussion paper on 20 November 2006.

The analogue pay-TV service was declared on 1 September 1999 in accordance with the Act. Since the declaration most pay-TV providers in Australia have transitioned their retail subscribers to digital pay-TV services, and 90 per cent of Australian pay-TV subscribers will be using digital cable or other technologies. As the regulation is no longer necessary to promote competition, a decision was made to revoke the declaration.

### **Discussion paper issued on licences for new digital television services**

On 15 December 2006 the ACCC issued a discussion paper seeking stakeholders' views on the access regime that will apply to 'Channel B', one of the two licences for new digital television services that will be made available by the government next year.

Possible uses for Channel B include mobile television and new services to in-home digital television sets.

Firms must have lodged an access undertaking that has been accepted by the ACCC before being eligible to participate in the allocation process for Channel B. The ACCC will be responsible for assessing access undertakings submitted by potential bidders for Channel B. The allocation process itself will be managed by the Australian Communications and Media Authority. Following the allocation of the licence to the successful bidder, the ACCC will have an ongoing role in overseeing the access regime, including any subsequent variations of the undertaking.



## Broadband snapshot— September 2006 quarters

The ACCC released its *Snapshot of Broadband Deployment*, detailing the deployment of broadband services throughout Australia for the September 2006 quarter. The September report released on 23 February 2007 showed total broadband take up was 3 639 700 as at 30 September 2006.

The report is based on data provided by major carriers of broadband services and includes aggregated data in relation to the availability of broadband services and gives estimated numbers of services in operation in respect of cable, satellite, ADSL, other DSL and miscellaneous offerings. However, not all broadband providers are included in the ACCC survey.

### Main findings—September 2006 quarter

- As at 30 September 2006 total broadband take-up was 3 639 700.
- Broadband take-up has increased by 1 232 300, or 51 per cent, from the September 2005 figure of 2 407 400.
- The take-up of ADSL services is now at 2 763 000.
- Total quarterly growth in broadband was at 9.3 per cent for the September 2006 quarter.

## Information paper on broadband speed claims

On 31 January 2007 the ACCC issued an information paper developed to assist internet service providers (ISPs) in complying with the Act when advertising broadband internet.

ISPs must not make representations that are misleading or deceptive, or are likely to mislead or deceive.

Although directed at all broadband providers, the paper focuses primarily on ADSL2+ broadband services. ADSL2+ is a relatively new technology and is currently becoming available to more and more consumers.

The paper draws attention to the industry practice of using hypothetical speeds as the basis of speed claims when these speeds are unlikely to be achieved in the real world. The ACCC considers that ISPs should have a reasonable basis, such as network tests, for any representations they make as to what speeds are available to future users of the network.

## Transport and Prices Oversight

### Airports price monitoring

On 22 February 2007 the ACCC issued its *Airports price monitoring and financial reporting 2005–06*. The report provides information on prices, costs and profits relating to the supply of aeronautical and aeronautical-related services at Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney airports.

The 2005–06 report shows that:

- Passenger numbers increased at all airports for the third consecutive year, most notably at Adelaide and Perth, continuing a trend that began in 1997–98 and was interrupted only in 2001–02 by a fall in traffic.
- Prices airlines paid to Australia's major airports for aeronautical services such as runways and passenger processing facilities generally increased, with aeronautical revenue per passenger (used as a proxy for prices) increasing at most airports, with the exception of Canberra, where it decreased slightly.

Indicative aeronautical-related charges (for car parking, check-in counters and aircraft light and emergency maintenance sites and buildings) increased at all airports, most significantly at Canberra and Melbourne. Car parking revenue contributed between 67 per cent and 98 per cent of aeronautical-related revenue at airports.

Aeronautical costs increased at most airports in 2005–06, partly as a result of greater security requirements for airports since 11 September 2001. Aeronautical operating costs on a per passenger basis increased at all airports except Darwin, but increased significantly at Adelaide, where a new terminal became operational.

The report also shows that aeronautical airport operating margins (the difference between the average revenue and the average operating expenses per passenger) generally increased at most airports in 2005–06. The exception was Canberra, where margins decreased. Margins per passenger ranged from \$1.44 at Brisbane to \$6.41 at Darwin.

Aeronautical profitability, measured as a rate of return on assets, increased at most airports, but decreased at Melbourne, Brisbane and Adelaide. However, in 2005–06 all airports continued to achieve positive earnings before interest, tax and amortisation expenses on average tangible non-current aeronautical assets.

The full report can be viewed on the ACCC website ([www.accc.gov.au](http://www.accc.gov.au)).

### Assessing cross-subsidy in Australia Post

The ACCC recently released *Assessing cross-subsidy in Australia Post 2005–06*, its second report into whether Australia Post is cross-subsidising its non-reserved services from its reserved services. The report presents findings from the ACCC analysis of Australia Post's regulatory accounts for the 2005–06 financial year.

Under s. 50H(2) of the *Australian Postal Corporation Act 1989* the ACCC must require Australia Post to keep records about its reserved services. In March 2005 the ACCC issued a record-keeping rule (RKR) that established a regulatory accounting framework for Australia Post. The primary purpose of the RKR is to allow the ACCC to monitor the presence of cross-subsidy.

The results of the ACCC's cross-subsidy analysis of Australia Post's 2005–06 regulatory accounts are similar to last year's findings. Its key findings are:

- The regulatory accounts do not provide evidence of cross-subsidy from Australia Post's reserved services to its non-reserved services.
- One non-reserved service group, logistics, was again the recipient of a subsidy in 2005–06. Revenue from logistics was less than the direct cost of providing that service by \$1.2 million; however, subsidy was supplied by the other non-reserved services.

The full report is available on the ACCC website ([www.accc.gov.au](http://www.accc.gov.au))

## Australian Energy Regulator

### Energy regulation

#### Electricity revenue resets

#### Powerlink Queensland transmission network revenue cap

On 8 December 2006 the AER made a draft decision on the revenue cap to apply to Powerlink from 1 July 2007 to 30 June 2012.

On 15 December 2006 the AER received a supplementary revenue cap proposal from Powerlink. This proposal seeks higher levels of capital expenditure resulting from new information (e.g. revised demand forecasts and higher input costs).



The AER received 13 submissions from interested parties on its draft decision and Powerlink's supplementary revenue cap proposal. The AER will consider the issues raised in these submissions when making its final decision. The AER anticipates releasing its final decision in May 2007.

Documents associated with the revenue reset, including AER's draft decision, Powerlink's application and supplementary revenue cap proposal, submissions from interested parties and consultant's reports can be found on the AER website ([www.aer.gov.au](http://www.aer.gov.au)).

### ***Final decision on re-opening TransGrid's revenue cap***

On 2 February 2007 the AER decided to revoke and substitute TransGrid's 2004–05 to 2008–09 revenue cap under clauses 6.2.4(d)(2) and 6.2.4(e) of the National Electricity Rules (NER). TransGrid requested this re-opening in November 2006 on the grounds that a material error was made when the revenue cap was set in 2005. The AER's reasons for this decision and the amendments to TransGrid's revenue cap can be found on the AER website ([www.aer.gov.au](http://www.aer.gov.au))

### ***Transitional pricing methodology arrangements for SP AusNet, VENCorp and ElectraNet***

Under the NER the AER is required to prepare a pricing guideline for TNSPs by 31 October 2007. The NER also require the AER to develop transitional pricing arrangements in consultation with SP AusNet, VENCorp and ElectraNet, to give effect to the process by which the AER will assess the TNSPs pricing methodology.

On 16 February 2007 the AER issued the agreed interim requirements, together with an explanatory statement, for SP AusNet, VENCorp and ElectraNet that will apply to their 2007 reset processes.

Documents associated with the interim arrangements are available on the AER website ([www.aer.gov.au](http://www.aer.gov.au)).

### **Gas Code decisions**

#### ***Roma to Brisbane Pipeline final decision***

On 20 December 2006 the ACCC released its final decision on APT Petroleum Pipelines Ltd's revised access arrangement for the Roma to Brisbane Pipeline, determining not to approve it in its then current form and specifying nine amendments.

APTPL submitted an amended revised access arrangement and access arrangement information to the ACCC on 28 February 2007. On 28 March 2007, the ACCC released its further final decision approving the amended revisions. The ACCC concluded that APTPL has substantially incorporated all of the required amendments and or otherwise satisfactorily addressed the matters identified as the reasons for requiring the amendments.

Documents associated with the access arrangement, including the ACCC's decisions, APTPL's proposals, submissions from interested parties and consultants' reports are available on the AER website ([www.aer.gov.au](http://www.aer.gov.au)).

#### ***Dawson Valley Pipeline proposed access arrangement***

On 5 February 2007 the ACCC received a proposed access arrangement and access arrangement information from Anglo Coal (Dawson) Limited, Anglo Coal (Dawson Management) Pty Ltd and Mitsui Moura Investment Pty Ltd, the Dawson Valley Pipeline (DVP) service providers.

The DVP transports gas 47 km from coal-seam methane gas fields in the Dawson Valley in Queensland to the Wallumbilla to Gladstone via Rockhampton Pipeline (the Queensland Gas Pipeline).

The AER received submissions from four interested parties on the proposed access arrangement—Molopo Australia Ltd, AGL Sales (Queensland) Pty Ltd, WestSide Corporation Ltd and Sunshine Gas Ltd. The ACCC anticipates the release of its draft decision in May 2007.

Documents associated with the access arrangement, including submissions, the proposal and the access arrangement information are available on the AER website ([www.aer.gov.au](http://www.aer.gov.au)).

#### ***Applications to waive ring-fencing obligations for the Dawson Valley Pipeline***

On 14 November 2006 the ACCC received applications to waive certain ring-fencing obligations from Anglo Coal (Dawson) Limited, Anglo Coal (Dawson Management) Pty Ltd and Mitsui Moura Investment Pty Ltd, the DVP service providers.

All three service providers sought a waiver of obligations under s. 4.1(b) of the Gas Code (related to carrying on a related business). Anglo Coal Ltd and Anglo Coal Pty Ltd also sought waivers of the obligations under ss. 4.1(h) and 4.1(i) (related marketing staff).

On 20 December 2006 the ACCC released its draft decision proposing to grant the waivers for marketing staff but not the related business waivers. Following consideration of submissions received in response to the draft decision, the ACCC released its final decision on 14 February 2007 to grant each waiver.

The ACCC's final decision and other documents on this matter are available on the AER website ([www.aer.gov.au](http://www.aer.gov.au)).

### ***NT Gas associate contract***

On 25 January 2007 NT Gas Pty Limited (NT Gas) requested the ACCC approve a contract with NT Gas Distribution (NTGD—an associated company) for the interruptible supply of gas. Under s. 7.1 of the Gas Code the ACCC must approve an associate contract unless it considers the contract would have the effect, or would be likely to have the effect, of substantially lessening, preventing or hindering competition in a market. The contract will expire on 1 January 2009. The ACCC undertook public consultation as part of the assessment process and approved the contract on 14 March 2007.

On 9 February 2007 NT Gas requested the ACCC approve a contract with NTGD, which effectively extended its current associate contract up to 15 June 2007 or to when the ACCC made a decision on the interruptible contract (whichever came first). This was to ensure that a contract would be in place should the ACCC decision not take place before the expiry of the existing contract on 15 March 2007. The ACCC approved this contract on 28 February 2007.

### **National Electricity Market**

#### ***Exposure Draft National Electricity Law Amendment Bill***

On 22 February 2007 the AER made a submission to the Ministerial Council on Energy's consultation process on the Exposure Draft of the National Electricity Law Amendment Bill. In its submission, the AER focused on the following points:

1. The National Electricity Law (NEL) access dispute arbitration arrangements should be aligned with the National Gas Law (NGL) and should also enable the AER to join other parties to an access dispute, and to join two or more separate disputes together.
2. Transitional arrangements should be provided for each jurisdiction's initial distribution regulatory reset, and a two-stage process should be used for electricity distribution regulatory resets.



3. The NGL ring-fencing provisions should be replicated in the NEL amendments, to provide consistent high-level ring-fencing arrangements across gas and electricity.
4. The AER's strong support for the proposed information collection and publication powers, because they will enhance the effectiveness of consultation processes and the capacity of stakeholders to assess whether legislative and rule settings meet their objectives and will more generally increase service-provider performance transparency and allow the market to become more informed.
5. The AER supports specific safeguards in relation to genuinely commercially sensitive information, including a net public benefit test that must be met before commercial information can be released.

The AER submission and the exposure draft are available at [www.mce.gov.au](http://www.mce.gov.au).

### **Retail Policy Working Group**

On 21 February 2007 the AER made a submission to the Ministerial Council on Energy's Retail Policy Working Group's third working paper. The RPWG is charged with development of the 2007 legislative package to complete the transfer of national distribution and retail regulation functions to the Australian Energy Market Commission (AEMC) and the AER.

The third working paper, which was developed by Allens Arthur Robinson (AAR), covered issues of business authorisation arrangements, ring-fencing and retailer failure arrangements. In its submission the AER commented on the proposals in the working paper, including its broad support for:

- the creation of a single national business authorisation regime
- robust ring-fencing arrangements, with the elevation of high-level ring-fencing principles, where appropriate, to the National Electricity Law
- a timeline—to be put in place as a matter of high priority—to facilitate policy decisions and workable legislation in respect of retailer failure arrangements.

The AER submission and previous AER submissions on the first two working papers can be found at [www.mce.gov.au](http://www.mce.gov.au), along with the RPWG's current and previous working papers. A fourth working paper by AAR is anticipated in March 2007 before an official consolidated working paper is issued for final public consultation.

### **Transitional transmission guidelines— issue of first proposed guidelines**

On 31 January 2007 the first proposed guidelines and accompanying explanatory statements for electricity transmission businesses were issued by the AER for public consultation. These guidelines are required under the new chapter 6A of the NER and the transitional provisions in clause 11.6.17.

The first proposed guidelines relate to the post-tax revenue model, the roll forward model, an efficiency benefit sharing scheme, a service target performance incentive scheme, submission guidelines and cost allocation guidelines

The consultation period is open until Tuesday, 1 May 2007, after which the AER will issue a determination on or before 30 September 2007.

Under a further transitional provision in clause 11.6.18 of the NER, the first proposed guidelines have been provided to ElectraNet, SP AusNet and VENCORP, to allow them to lodge their revenue proposals for the 2008 regulatory determinations in the coming months.

The AER is required to develop and/or maintain a number of other guidelines as part of transmission regulatory guidelines package. The AER will develop and will issue these guidelines separately.

Information on the guidelines and the consultation process is available the AER website ([www.aer.gov.au](http://www.aer.gov.au)).

### **Markets**

On 2 March 2007 the AER released its quarterly compliance report for October to December 2006 detailing monitoring and enforcement activities during that period. The report also provides an overview of the results of AER investigations (which were published separately) and the results of the AER's targeted compliance program.

The AER released two price reports on 14 February and 21 February 2007, detailing the events of 11 January and 16 January 2007, when the 30-minute spot price exceeded \$5000/MWh.

A price report detailing the events of 23 and 24 January, when the 30-minute spot price exceeded \$5000/MWh, will be published shortly.

The AER continues to publish weekly market analyses setting out the spot price for each 30-minute trading interval in each region of the National Electricity Market. These reports and other related monitoring publications are available on the AER website ([www.aer.gov.au](http://www.aer.gov.au)).

## Victoria

### Essential Services Commission

#### Gas Access Arrangement Review 2008–12

Victoria's three major gas distribution pipeline networks—Multinet, SP AusNet and Envestra—submitted their proposed access arrangements for the 2008–12 period to the Essential Services Commission (ESC) on 30 March 2007.

Envestra also submitted separate revisions to the access arrangement for its Albury network.

ESC approves the terms and conditions of access arrangements for third party users wanting to access services offered by gas distributors in Victoria.

It will now conduct a formal review process, as set out in the National Third Party Access Code of Natural Gas Pipeline Systems (the Gas Code), and determine whether to approve the proposed access arrangements.

ESC is expected to release a draft decision on the Gas Access Arrangement Review in late June or early July, with a final decision set for September.

The proposed access arrangements will apply from 1 January 2008 to 31 December 2012.

All material relating to the review, including the submissions made by the distribution companies, is available on the ESC website ([www.esc.vic.gov.au](http://www.esc.vic.gov.au)).

#### Small-scale exemption framework

ESC has concluded its review of the exemption framework for the distribution and retailing of energy on a small scale.

Final recommendations by ESC were forwarded in March to the Victorian Minister for Energy and Resources, following a long-year review.

In March 2006 the Minister for Energy Industries requested ESC to review the small-scale exemptions framework. In particular, the minister sought advice on how the exemption framework could accommodate small-scale energy distribution and selling activities.

The exemption framework concerns the supply and sale of energy to consumers who share a defined geographic boundary—e.g. residential apartments, shopping centres, retirement villages and caravan parks.

Under Victoria's *Electricity Industry Act 2000* and its *Gas Industry Act 2001*, distributors and retailers of electricity or gas must hold a licence unless they are exempt from this requirement.

For electricity distribution and retailing, general exemptions are specified in an Order-in-Council that came into effect on 1 May 2002. An entity may also obtain a specific exemption from the Governor-in-Council.

There is no general Order-in-Council applying to the distribution and retailing of gas in an embedded network; consequently an operator of an embedded network requires a licence to distribute or retail gas unless a specific exemption has been granted by the Governor-in-Council.

In seeking the review undertaken by ESC, the minister indicated that the Victorian Government would prefer not to rely on the Order-in-Council as the primary regulatory instrument for embedded customer situations.

In December 2006 ESC released the review's draft recommendations, which included a proposed registration system for small-scale energy activities, with ESC monitoring compliance with obligations.

#### Victorian renewable energy target scheme

The *Victorian Renewable Energy Act 2006* was passed by the Victorian Parliament in September 2006. It established the Victorian renewable energy target (VRET) scheme, which mandates that Victoria's consumption of electricity generated from renewable sources be increased to 10 per cent by 2016.

The scheme involves the creation, acquisition and surrender of renewable energy certificates with the objective of encouraging additional generation of electricity from renewable sources.

Under the legislation ESC will administer the VRET scheme.

With the scheme in operation since 1 January 2007, ESC has developed final rules to apply to registrants. These rules will cover areas such as the accreditation of power stations for renewable energy certificates, eligibility of renewable energy sources, acquisitions of electricity and surrender of certificates.

#### Compliance report for Victorian energy retail businesses

In March 2007 ESC released its first annual compliance report for the Victorian energy retail businesses, which outlines activities under its compliance policy.

These activities include addressing material and systemic issues arising from complaints referred by the public, the Energy and Water Ombudsman (Victoria) and other parties, and investigating breaches of the regulatory instruments reported by the regulated energy businesses.

Energy retailers are required to comply with a number of statutory and regulatory obligations in the competitive energy market, including non-energy specific obligations.

Given their obligations and the increasing number of retailers (more than ten) currently active in selling energy to small customers in Victoria, compliance performance by Victorian energy retailers in 2005–06 was considered to be generally good.

The compliance report identified instances of multiple breaches of certain obligations, particularly billing errors and marketing conduct. There were also instances where retailers did not comply with their statutory and regulatory obligations to disclose product information or failed to adequately seek customer acknowledgement of, and agreement to, potential price and terms variation in contracts.

The report outlines breaches by the individual retailers and the actions taken by the relevant parties to remedy the breaches.





## South Australia

### Essential Services Commission of South Australia

#### Energy

##### **Effectiveness of Energy Retail Market Competition in South Australia**

During 2007 the Essential Services Commission of South Australia will review the retailer component of electricity standing contract prices in South Australia, which will apply for at least three years from 1 January 2008. AGL can charge such prices to residential and small business customers receiving electricity under the standing contract established by ESCOSA.

ESCOSA will also review gas standing contract prices charged by Origin Energy, to apply for a period of at least three years from 1 July 2008.

ESCOSA has commenced a review of the effectiveness of retail market competition in South Australia (incorporating both electricity and gas). This will provide insights into the competitive pressures faced by the electricity and gas standing contract retailers, and may influence the form of price regulation established by ESCOSA for electricity and gas for the next price path period.

In addition, it may suggest ways for ESCOSA to enhance its efforts to further promote energy retail market competition in South Australia, and indicate areas in which better data will need to be gathered to enable future competition reviews to be conducted.

NERA Economic Consulting will assist in conducting the review, which will build on ESCOSA's extensive work over several years in monitoring and reporting publicly on the South Australian energy retail market. The competition review is due to be completed by April 2007.

ESCOSA is consulting closely with the Australian Energy Market Commission on the conduct of a competition review and the possible interaction of such a review with any future review undertaken by AEMC.

##### **Release of annual performance reports**

In November 2006 ESCOSA released the following reports dealing with the performance of regulated businesses during 2005–06:

- Performance of Energy Retail Market
- Performance of Energy Network Businesses
- Regulatory Compliance Report.

The *Performance of Energy Retail Market* report details the performance of electricity and gas retailers serving the small customer (residential and small business) segment of the South Australian energy retail market. The report includes detailed discussion of the ongoing development of the market and retailers' performance against the service standards established under the ESCOSA Energy Retail Code.

The *Performance of Energy Network Businesses* report outlines key aspects of the performance of the regulated electricity distribution business (ETSA Utilities), gas distribution business (Envestra) and electricity transmission business (ElectraNet) during 2005–06.

The *Regulatory Compliance Report* outlines ESCOSA's regulatory compliance and enforcement regime and the degree of compliance with it by regulated entities in the energy and rail sectors. ESCOSA notes that compliance systems and reporting have improved over recent years and that levels of compliance with regulatory obligations are generally at an acceptable level.

##### **Licensing**

Energy One Ltd lodged applications with ESCOSA in February 2007, seeking electricity and gas retail licences. ESCOSA is now seeking public comment on those applications.

ESCOSA issued a gas retail licence and an electricity retail licence to Jackgreen (International) Pty Ltd in September 2006.

##### **Electricity**

##### **Finalisation of the Heatwave Inquiry: variation to the Electricity Distribution Code**

ESCOSA has released its final decision on amendments proposed to the Electricity Distribution Code. The amendments arose as a result of the ESCOSA inquiry into the January 2006 heatwave and were the subject of a public consultation process. Most significantly, ESCOSA has amended the EDC to provide greater regulatory incentives for ETSA Utilities to deliver better customer service, particularly in relation to network outages and network performance during extreme weather events. These amendments took effect on 1 January 2007.

##### **Final report on the electricity distribution efficiency carryover mechanism**

In March 2007 ESCOSA released its final report on the efficiency carryover mechanism to determine how efficiency gains and losses experienced by ETSA Utilities during the 2005–2010 regulatory period will be carried forward to the next regulatory period.

As well as the final report, ESCOSA also published a statement of regulatory intent, setting out the proposed efficiency carryover mechanism.

##### **Electricity Distribution Price Determination—Part B**

ESCOSA has identified that the term 'metering services', which appears in clause 1.6(b)(i) of Schedule 1 of Part B of the Electricity Distribution Price Determination and which took effect on 1 July 2005, should instead be 'meter provision services' and has changed that clause accordingly.

This change reflects ESCOSA's intention, as specified in ss. 2.4 and 2.5 of Part A of the determination, that meter provision services for metering installations types 1 to 4 installed before 1 January 2000 should be prescribed distribution services. Only meter data services in respect of such meters were intended to be excluded services.

##### **Power Line Environment Committee—'Out of sight, but not out of mind' report**

To mark the Power Line Environment Committee's fifteenth year of operation, a report titled *Out of sight, but not out of mind* has been produced to note some of the achievements of the undergrounding program in South Australia and to show where funding has been distributed.

The Power Line Environment Committee (PLEC) undergrounding program represents a partnership between ETSA Utilities and councils, with input from the Department for Transport, Energy and Infrastructure and Telstra. The program results in aesthetic and economic benefits for the community in tourism, heritage and commercial activities.

##### **PLEC Annual report 2005–06**

The PLEC *Annual report 2005–06* was forwarded to the Minister for Energy in September 2006. The report summarises projects constructed and details of funding allocated by the committee to future projects during the 2005–06 year.



## Licensing

On 9 January 2007 ESCOSA issued an electricity generation licence to Snowtown Wind Farm Pty Ltd (a subsidiary of TrustPower Ltd), authorising the operation of an 88MW wind farm in the Barunga Ranges, just west of Snowtown in mid-north South Australia. This brings the total capacity of wind farms licensed by ESCOSA to almost 800MW.

## Gas

### 2006 Review of Envestra Gas Access Arrangement

On 27 October 2006, as required under the National Third Party Access Code for Natural Gas Pipeline Systems, ESCOSA issued a further final decision on revisions proposed by Envestra Ltd to the access arrangement for its gas distribution system in South Australia.

This further final decision detailed ESCOSA's response to the amended revisions to the access arrangement and the amended access arrangement information submitted by Envestra following the issue of ESCOSA's final decision on 30 June 2006.

In this final decision ESCOSA did not approve all Envestra's proposed revisions because they did not meet Access Code requirements. Accordingly, ESCOSA required Envestra to submit amended revisions to the access arrangement and the accompanying access arrangement information, to satisfy the matters raised in its final decision.

ESCOSA did not approve all Envestra's amended revisions to the access arrangement because they did not incorporate, or substantially incorporate, or satisfactorily address the reasons for, the amendments specified in ESCOSA's final decision (s. 2.41 of the Access Code). ESCOSA then drafted and approved its own amended revisions to the Access Arrangement (s. 2.42). The revised access arrangement is effective from 13 November 2006 to 30 June 2011.

As detailed in its further final decision, ESCOSA was also not satisfied that the amended access arrangement information met Access Code requirements. Consequently, ESCOSA drafted and approved an explanatory document, the *Access Arrangement Explanatory Information*, which explains key aspects of the approved revised access arrangement.

ESCOSA's decision allows haulage reference tariff increases of 0.2 per cent above the consumer price index per year from 1 July 2007. The decision also includes a 70 per cent real increase in capital expenditure over that from the first access arrangement period. This includes provision for:

- 100 km of cast-iron and unprotected steel mains replacement in each year of the regulatory period
- improvements to security of supply in the gas distribution system (including improvements on the Le Fevre Peninsula, in Adelaide's northern suburbs, a new gate station for the SEA Gas pipeline and interconnection between the SEA Gas and Moomba to Adelaide Pipelines)
- new reticulation to the townships of McLaren Vale, Monarto Industrial Estate and Tanunda
- recognition that the expenditures associated with specific major projects (the Eastern Ring Main, Southern Loop and central business district mains replacement) may be incorporated into total revenue if those projects are actually required to be undertaken during the five-year period.

ESCOSA also included a 12.3 per cent real increase in operating expenditure, thus allowing for the ongoing operation of the gas distribution system under the regulatory requirements.

On 10 November 2006 Envestra lodged an application for a review of certain aspects of ESCOSA's decision under s.39(1) of Schedule 1 of the *Gas Pipelines Access (South Australia) Act 1997*. The matter is now before the District Court of South Australia Administrative and Disciplinary Division.

## Ports

### 2007 Ports pricing and access review: issues paper

In February 2007 ESCOSA released an issues paper to begin reviewing the pricing and access regimes that apply to seven commercial ports in South Australia. The review will incorporate an inquiry into the ports access regime.

The review will consider whether the current regimes, including a negotiate and/or arbitrate framework for ports access coupled with price monitoring, should continue beyond 30 October 2007 for a further three-year period. If the regimes are to continue, ESCOSA will consider any changes that may improve their effectiveness.

## Ports Price Monitoring

In September 2006 ESCOSA published its *2006 Ports price monitoring report* under the price monitoring regime (as in its *2004 Ports Price Determination*) applying to essential maritime services. This report provides port customers and the community with an indication of port costs in South Australia and at nominated Australian ports over time.

## Water

### Inquiry into the 2007–08 water and wastewater pricing processes: issues paper

On 9 February 2007 ESCOSA published an issues paper about the 2007–08 water and wastewater pricing processes inquiry.

Under the inquiry's terms of reference, ESCOSA was required to inquire into price setting processes used in preparing advice to Cabinet, to allow Cabinet to make a decision on the level and structure of SA Water's water and wastewater prices in metropolitan and regional South Australia in 2007–08 and an in-principle revenue direction to June 2012. ESCOSA will submit a final report to the Treasurer early in June 2007.

## Corporate

### Corporate strategy: key issues for the 2007–08 work program

Each year ESCOSA prepares a strategic plan with a three-year timeframe. This plan focuses specifically on the agency's work program for the first 12 months of that three-year period. The plan is then submitted to the Treasurer for approval under s.23 of the *Essential Services Commission Act 2002*.

Before the strategic plan is developed, ESCOSA releases a discussion paper outlining possible key issues and seeks comment on the relevance of those issues to its work. Stakeholder feedback is then incorporated into the work program submitted to the Treasurer for approval.

ESCOSA released its 2007 discussion paper in February. Stakeholder feedback on the issues raised in this paper will be an important component in the development of ESCOSA's 2007–10 strategic plan, particularly for the 2007–08 work program.

### Annual report 2005–06

Under the Essential Services Commission Act, ESCOSA forwarded its 2005–06 annual report to the Treasurer on 29 September 2006, for subsequent tabling in Parliament.

### Economic Regulation Authority

#### Electricity

##### Network access

On 26 May 2007 the Economic Regulation Authority (ERA) issued its further final decision on Western Power's amended proposed access arrangement for the South West Interconnected Network (SWIN). ERA decided to approve the amended proposed access arrangement on the grounds that it either implemented the amendments required in the final decision or adequately addressed the matters that prompted ERA to require amendments. This access arrangement will apply until 30 June 2009.

ERA also approved and published technical rules for Western Power's SWIN at the same time the approved access arrangement was published. The technical rules consist of network benchmarks and standards, procedures and planning criteria.

The final decision, which did not approve the proposed access arrangement at that stage, was issued on 2 March 2007.

The detailed reasons for ERA's decisions are set out in the final and further final decision documents available on ERA's website.

ERA's final decision was issued after extensive public consultation, including on the proposed amendments to the *Electricity Networks Access Code 2004*, under which the revised proposed access arrangement was assessed.

Under s. 4.19 of the Access Code, Western Power may submit an amended proposed access arrangement to ERA within 20 business days of this final decision. ERA is then required (under s. 4.21 of the Access Code) to issue a further final decision either approving or not approving the amended proposed access arrangement. If ERA does not approve the amended proposed access arrangement, it will be required to draft and approve its own access arrangement.

ERA is also required to approve and publish technical rules for Western Power's SWIN at the same time the approved access arrangement is published. The technical rules consist of network benchmarks and standards, procedures and planning criteria.

Contact (access arrangement): Alison Ovenden  
(08) 9213 1961

Contact (technical rules): Nick Parkhurst  
(08) 9213 1933

#### Wholesale Electricity Market monitoring

The Western Australian Wholesale Electricity Market (WEM) has a capacity market and an energy market, which consists of a bilateral energy market and a short term energy market (STEM) and a balancing market.

Since the commencement of WEM on 21 September 2006, the volume traded in the bilateral market has been relatively stable. The STEM volume, on the other hand, has varied since the market was established.

WEM started off with fairly high STEM prices, but prices have declined and are currently averaging around \$35/MWh.

ERA has a role in monitoring the effectiveness of WEM. In addition, the Wholesale Electricity Market Rules require ERA to monitor, with the assistance of the Independent Market Operator (IMO), generators that do not offer to sell electricity into STEM reflecting their short run marginal costs. Generators who do not sell into STEM reflecting their short run marginal costs (where such behaviour relates to the abuse of market power) are subject to penalties under the market rules. ERA is currently working with the IMO to monitor the behaviour of generators in WEM to ascertain compliance with this aspect of the market rules.

ERA is also responsible for approving the maximum reserve capacity price. On 30 January 2007 ERA approved the maximum reserve capacity price of \$142 200/MW proposed by the IMO for the 2009–10 capacity year in accordance with the requirements of the market rules.

In addition, the WEM rules require ERA to assess and determine the allowable revenues proposed by the IMO and System Management (the latter being a segregated entity of Western Power). On 30 March 2007 ERA determined the allowable revenues of the IMO and System Management from 1 July 2007 to 30 June 2010. As required by the market rules, ERA undertook public consultation and submissions received were considered in making the determinations.

Contact: Ignatius Chin (08) 9213 1916

#### Rail

##### Review of WestNet Rail's floor and ceiling costs

ERA has commenced a review of the floor and ceiling costs for certain rail lines in the WestNet Rail network. The floor and ceiling determinations will apply over a three-year period.

The rail lines included in the review are as follows:

- Kwinana to Bunbury Inner Harbour
- Forrestfield to Kalgoorlie
- Leonora to Kalgoorlie
- Kalgoorlie to Esperance
- Brunswick Junction to Collie
- terminal ends of the Kwinana to Bunbury Inner Harbour
- Avon to Goomalling
- Katanning to Tambellup
- Kulin to Yilliminning.

ERA has completed a public consultation process in respect of the proposed floor and ceiling costs submitted by WestNet Rail for the rail lines above and issued its draft determination on 20 March 2007. A copy of the draft determination and a consultant's report are available on the ERA website ([www.era.wa.gov.au](http://www.era.wa.gov.au)).

Contact: Michael Jansen (08) 9213 1952



## Licensing

### **Review of gas trading and distribution licences**

A review of the gas trading and distribution licences is nearing completion. A recommendation report, including model draft licences, was published on the ERA website in December 2006. Stakeholder feedback has revealed strong support for the intent of the review, which is to amend the licences so they align, where possible, with electricity licences.

The Review Reference Group will soon be convened to consider the final version of the new licence and attached schedules.

Following this process, recommendations will be submitted to ERA's governing body for final approval, after which the new licence will become available.

Contact: Mick Geaney (08) 9213 1900

### **Licence application guidelines**

Licence application guidelines, developed to provide all licence application information and advice in one easy-to-access document, are now available on the ERA website ([www.era.gov.au](http://www.era.gov.au)).

The guidelines are for those seeking to apply for a licence to:

- generate, distribute, transmit or sell electricity
- distribute or sell gas or
- provide a water service.

Contact: Mick Geaney (08) 9213 1900

### **Licences issued or amended**

ERA has begun four amendments and received six amendment requests since November 2006.

The following table shows the licence type, the licensee and the amendment.

<b>Licence</b>	<b>Licensee</b>	<b>Amendment</b>
Electricity distribution licence 3 and electricity transmission licence 4	TEC Desert Pty Ltd and TEC Desert No. 2 Pty Ltd trading as Southern Cross Energy Partnership	Reformat licence maps to conform with the ERA standard.
Electricity distribution licence 2 and electricity retail licence 2	BHP Billiton Nickel West Pty Ltd	Change of name from Nickel West (ABN 76 004 184 598) to BHP Billiton Nickel West Pty Ltd (ACN 004 184 598).
Electricity generation licence 5	Transfield Services Kemerton Pty Ltd	Change the output capacity of the power station from 160.9 MW to 310 MW.
Gas trading licence 6	WorleyParsons Asset Management Pty Limited	Change of name from BRW Power Generation (Esperance) Pty Ltd to WorleyParsons Asset Management Pty Limited.
Gas distribution licence 4 and gas trading licence 4	Wesfarmers Kleenheat Gas Pty Ltd	Amendments to expand operating area to include Hopetoun and surrounds pending public submission period.
Operating licence 32	Water Corporation	Amendments to drainage provisions in Schedule 7 pending public submission period.
Operating licence 32	Water Corporation	Changes to reporting requirements in line with National Water Initiative.
Operating licence 2 (Water supply services)	Bunbury Water Board trading as Aqwest-Bunbury Water Board	Changes to reporting requirements in line with National Water Initiative.
Operating licence 3 (Water supply services)	Busselton Water Board	Changes to reporting requirements in line with National Water Initiative.
Operating licence 4 (Non-potable supply services)(Sewerage services)	City of Kalgoorlie-Boulder	Changes to reporting requirements in line with National Water Initiative.



## Monitoring

### Asset management workshop

ERA conducted an asset management planning workshop in February 2007 to help local government authorities better manage their wastewater services.

The workshop followed a recent review of asset management systems by ERA that identified a range of issues.

The workshop was developed with GHD Pty Ltd and was specially tailored for small water licensees. Participants were provided with a generic asset management software package developed specifically for small water licensees.

Contact: Paul Reid (08) 9213 1900

### Electricity compliance reporting manual

ERA has approved an electricity compliance reporting manual to help licensees meet their obligations and to improve stakeholder understanding of their compliance reporting requirements, which are contained in a number of legislative and regulatory instruments.

The manual was issued on 24 January 2007 and includes details of:

- compliance reporting requirements, including the timing and format of reporting
- licence conditions and obligations.

Public consultation on a previous draft of the manual concluded last August. The manual was amended as a result of the consultation with key changes, including:

- Introducing additional performance reporting requirements for distribution and retail licensees. The additional requirements were sourced from Standing Committee on National Regulatory Reporting Requirements reports for 2002 and 2006.
- Amending licence obligation reporting classifications, with ERA setting out the following classification criteria and reporting requirements:
  - major—immediately reportable due to the major consequence
  - moderate—reportable annually
  - minor—not reportable.

## Customer protection

### Gas marketing code of conduct review

The Gas Marketing Code of Conduct 2004 was designed to:

- regulate and control the conduct of the holders of gas trading licences and gas marketing agents to protect customers from undesirable marketing conduct
- define standards of conduct in the marketing of gas to customers.

ERA administers the Gas Marketing Code, and established the Gas Marketing Code Consultative Committee (GMCCC). The committee advises ERA on Gas Marketing Code matters and is responsible for undertaking a review of the Gas Marketing Code as soon as practicable after the first anniversary of its commencement.

The Gas Marketing Code review began in late 2005. A principles paper outlining the key aspects of the review was released on 3 January 2006, with submissions closing on 28 February 2006. The submissions received supported the approach proposed in the principles paper for undertaking the review.

The GMCCC draft code review report was released on 11 August 2006 and the final report was published on 2 March 2007 following public consultation. The final report recommended the repeal of the Gas Marketing Code and the creation of a gas marketing standard as a condition of gas trading licences. It also recommended that ERA publish information to assist consumers. On 26 March 2007 the Authority released a decision document endorsing the recommendations contained in the GMCCC final report.

Contact: Michael Styles (08) 9213 1922

### Electricity code of conduct review

The Electricity Code Consultative Committee (ECCC) is reviewing the Code of Conduct for the Supply of Electricity to Small Use Customers and has produced a draft report. Public consultation on the draft report began on 23 February 2007, with submissions required by 5 April 2007.

After the ECCC has reviewed submissions and approved the review's final report, the material will be provided to ERA for consideration in May 2007.

More information is available on the ERA website ([www.era.wa.gov.au](http://www.era.wa.gov.au)).

Contact: Lanie Chopping (08) 9213 1900

## Amendment of electricity supply code of conduct

ERA proposes to exercise its power under the *Electricity Industry Act 2004* and make the following amendment to clause 9.6(b) of the Code of Conduct for the Supply of Electricity to Small Use Customers:

- 9.6 (b) a pre-payment meter customer:
- other than a customer within an ARCPSP community can access a **recharge facility** between the hours of 9:00am to 5:00pm, Monday to Friday;
  - within an ARCPSP community can access a recharge facility at least three hours per day, five days per week within the hours determined by the Aboriginal Corporation or relevant entity responsible for the community store facility.

The amendment is to ensure that the code prescribes appropriate opening hours for the communities participating in the Aboriginal remote communities power supply program. The Minister for Energy requested that ERA make the amendment urgently to address the potential delay created by issues with the existing clause.

In exercising its power to amend the code, the *Electricity Industry Act* requires ERA to refer the proposed amendment to the ECCC for its advice. The ECCC consulted publicly on this matter and has provided advice to ERA.

## References

### Inquiry on school bus operators' charter bus operations

On 22 January 2007 the Western Australian Treasurer requested an inquiry by ERA into the charter bus operations of school bus operators.

In accordance with the inquiry's terms of reference, ERA is to consider and report on:

- the impact that participation by school bus contractors in the commercial bus charter industry has on competition, prices and pricing policy; investment and business practices; and service quality and reliability in the industry
- the revenues and costs of school bus contractors under their contracts with the Public Transport Authority; and
- whether, and how, the service charge model in the school bus service contracts could be amended to remedy any competitive unfairness which might arise from the participation by school bus contractors in the commercial bus charter industry.



ERA has published an issues paper to explain the nature of the issues under review and to facilitate public comment and debate.

ERA's draft report will be published shortly with public submissions on the report being invited. The final report will be published as soon as possible after submissions have been considered, with subsequent tabling in parliament.

Contact: Ursula Kretzer (08) 9213 1900

### **Inquiry on Harvey Water bulk water pricing**

On 5 October 2006 the Western Australian Government directed ERA to conduct an inquiry into the Water Corporation's water storage charges levied on the South West Irrigation Cooperative (Harvey Water). The inquiry is the first independent evaluation of water charges to irrigators in Western Australia and will have direct input from the public.

In accordance with the inquiry's terms of reference, ERA will make recommendations to the government on the level and structure of water storage charges to Harvey Water.

ERA published an issues paper to assist stakeholders to understand the nature of the matters under review and to facilitate public comment and debate.

Following consideration of responses made to the issues paper, ERA published a draft report and invited submissions on any matter raised in the draft report or in the terms of reference.

The inquiry's final report was delivered to the government on 12 April 2007, for subsequent tabling in parliament.

Contact: Greg Watkinson (08) 9213 1900

## **Australian Capital Territory**

### **Independent Competition and Regulatory Commission**

#### **Water and wastewater**

The ACT Government has directed the Independent Competition and Regulatory Commission (ICRC) to undertake a review of ACTEW Corporation's water and wastewater network, and to make a price determination to apply from the expiry of the current price determination on 30 June 2008.

The ICRC released a discussion paper on the technical regulatory issues in November 2006, and a further discussion paper on the WACC calculation in March 2007. A third paper on pricing options will be released in May 2007. Submissions on the discussion papers are due in late June 2007.

Submissions made on the discussion papers will assist the ICRC to develop its working assumptions paper, due for release in July-2007. Submissions on this paper will inform the ICRC's draft decision, which will be released in November 2007. A public hearing and an opportunity for further submissions will follow the release of the draft decision before the ICRC releases its final decision by 1 March 2008.

#### **Electricity distribution**

The ICRC is proposing to amend its 2004 price direction for ActewAGL Distribution's electricity distribution network. The proposed amendment is in response to the introduction of a network facilities tax by the ACT Government in late 2006. The NFT is a tax levied upon utilities, including ActewAGL Distribution, in the ACT on the basis of the length of their networks.

The NFT cannot be passed through to customers under the pass-through provisions contained in the 2004 electricity distribution price direction as the wording of the direction limits the pass-through of a change in taxes to Commonwealth taxes only.

The proposed amendment will give the ICRC the ability to consider whether it should allow ActewAGL Distribution to recover costs incurred as a result of a change in taxes imposed by state or territory governments.

The ICRC has released a draft decision outlining the proposed amendment. Submissions on the draft decision are due by 18 April 2007, with a final decision expected by 27 April 2007.

#### **Annual price resets**

The ICRC is currently in the process of undertaking annual price resets for ActewAGL Distribution's electricity and gas networks and ACTEW Corporation's water and wastewater network.

#### **Electricity retail**

In April 2006 the ICRC released its *Retail prices for non-contestable electricity customers* report, in which it concluded that the ACT electricity retail market demonstrated competitive market characteristics and was sufficiently competitive to allow the removal of the regulated retail tariff applying to customers on a 'standard customer contract'. The standard customer contract effectively serves as a default contract for customers who do not choose to enter into a 'negotiated customer contract'. Both standard and negotiated contracts are regulated under the *Utilities Act 2000*.

In its report the ICRC also noted the possible implications of removing the regulated retail tariff, including the possible impact on safeguards aimed at protecting small customers—such as the obligation to supply—that exist under the current arrangements.

The ICRC recommended a transitional franchise tariff to apply from 1 July 2006 to 30 June 2007, which would provide sufficient time to amend the Utilities Act to retain customer protection. It has now been determined that legislative change is not required to ensure customer protection for those customers continuing under the non-negotiated standard reference tariff. The Government has, however, issued terms of reference for the commission to determine a retail tariff for customers who do not take up a negotiated contract for the supply of electricity. The new retail tariff is to apply for a 12-month period from 1 July 2007. The commission is commencing a brief review and will shortly be releasing a draft report for comments from the general community.

#### **Electricity Network Use of System Code**

The Electricity Network Use of System Code is an industry code under s. 4 of the Utilities Act. The code requires electricity distributors and suppliers to enter into agreements that address certain terms prescribed in the code. However, the code does not specify a time in which agreements must be reached, nor does it make provision for the ICRC to intervene when agreement cannot be reached.

The ICRC is concerned about the unacceptably high number of electricity suppliers that have not yet signed network use of system agreements with ActwAGL Distribution. This concern has led to the ICRC asking ActewAGL Distribution to provide it with draft variations to the Electricity Network Use of System Code, to establish a default agreement if agreement cannot be reached in a timely manner between the electricity distributor and an electricity supplier.

The ICRC is currently considering ActewAGL Distribution's proposed amendments to the code and the submissions made to it. The ICRC is anticipating that the amendments will be approved in April 2007.



### Ambulance Service pricing

The ICRC has been asked to investigate and make recommendations on the pricing policies of the ACT Ambulance Service. The reference specifically requires the ICRC to consider the pricing approach in a paper prepared by the Essential Services Authority on behalf of the Ambulance Service.

The ICRC released a draft report in April 2006 and will shortly release a final report. The delay in completing the final report reflects decisions made by the Government in its 2006–07 Budget to implement some parts of the recommendations in the draft report, and the need to review aspects of the New South Wales Government’s decision on the funding of ambulance services in that state.

## New South Wales

### Independent Pricing and Regulatory Tribunal

#### Electricity retail

On 30 June 2006 the Minister for Energy referred the determination of regulated retail tariffs and charges for each distribution area in New South Wales to the Independent Pricing and Regulatory Tribunal (IPART), for investigation and reporting from 1 July 2007 to 30 June 2010.

On 14 July 2006 IPART released an issues paper calling for comment on the main matters for consideration and setting out the review process. IPART will release a draft report and determination in April 2007, and a final report and determination by mid-June 2007.

#### Gas retail

On 30 June 2006 the Minister for Energy requested that IPART continue regulating default tariffs for small retail customers and ensure that either new voluntary pricing principles or a gas pricing order under the *Gas Supply Act 1996* operate until 30 June 2010. IPART expects to release draft voluntary pricing principles in April 2007.

### Transport

#### Taxi fares

IPART is currently reviewing the form of regulation for taxi services. Submissions have been received and it is expected that IPART’s final report will be released in April. At the same time, IPART will call for submissions for the next fare review.

#### Rail access

IPART is reviewing the compliance of the Hunter Valley coal network infrastructure owners with the New South Wales Rail Access Undertaking for 2005–06.

### Water pricing

#### Recycled water review

The current drought is placing severe stress on the traditional water supplies sourced from rivers and dams in the urban areas of Sydney and in the Blue Mountains, Illawarra, Central Coast and Hunter regions of New South Wales. As a consequence, there is an urgent need to find alternative sources of supply to help secure water supplies into the future and to cater for growth.

In February 2006 IPART began a review of pricing arrangements for recycled water services provided by the Sydney Water Corporation, Hunter Water Corporation and the Gosford and Wyong councils by releasing an issues paper and inviting interested parties to make submissions.

IPART’s extensive program of consultation and deliberation included holding a public hearing into the most appropriate arrangements for the pricing of recycled water services. IPART also released a draft report and invited comment and submissions on that report before concluding its inquiry with the release of a final report on 21 September 2006.

At the time the review commenced it was not clear whether all recycled water prices should be regulated by it, given that:

- a large number of separate schemes are likely to operate
- large customers and land developers have sufficient bargaining power to negotiate a mutually acceptable price with water utilities
- the costs of individual schemes are largely unknown, as is market demand
- in some instances connection will be voluntary and in others it will be mandatory
- access to potable water creates a price ceiling or backstop price for consumers, providing consumer protection.

IPART had to decide whether recycled water prices should be regulated and, if so, in which circumstances. The recycled water market has been divided into mandatory and voluntary areas of recycled water use.

Using recycled water will be mandatory in some large new green-field development areas. A third pipe network will be installed in these areas and recycled water plumbed to toilets and laundries. IPART decided that it would not set discrete prices for each recycled scheme but would specify pricing guidelines that water utilities will need to follow when calculating prices for recycled water services in each application.

IPART adopted this approach because most of these schemes have not yet been built and their costs are unknown, and IPART does not have sufficient information available to it to allow it to set prices at this time. IPART will monitor the compliance of water utilities with the guidelines over time.

IPART’s guidelines provide that:

- As a general rule the costs of recycled water schemes should be recovered from the users of the scheme.
- Prices should be set to reflect costs on a scheme-by-scheme basis.
- Where a recycled water scheme results in costs being avoided or deferred elsewhere in water and sewerage systems, the value of these avoided or deferred costs can be recovered from water and sewerage customers.
- Recycled water prices are to include a usage component that is to not exceed the cost of potable water without IPART’s approval being obtained.
- If a recycled water scheme is to be topped up with potable water by more than 10 per cent of the volume used, prices are to be linked to the potable water price. Where topping up with potable water is expected to exceed 20 per cent, the recycled water price is to be set equal to the potable water price.

IPART was mindful that in urban New South Wales potable water prices are equated with the long run marginal cost of water, which reflects the cost of the next supply increment. Pricing water at this level signals to water users the cost consequences of their current consumption patterns.



If a recycled water scheme requires topping up with potable water, the cost of the next unit of recycled water—the marginal cost—is the price of potable water. IPART believes that it makes no sense to top up a recycled water scheme with potable water and then sell recycled water for less than the incremental cost of that potable water.

For voluntary recycled water schemes where customers may choose whether to use the recycled water, IPART decided that prices could best be determined by direct negotiation between the water utility and the potential recycled water user.

IPART has developed principles to assist water utilities with negotiations. These principles provide that costs should be fully recovered with the exception of avoided costs, subsidies received, etc. The principles also provide for prices to be structured in such a way as to send appropriate price signals to users.

### **Bulk water pricing**

IPART has completed its review of the charges to be applied for the extraction of bulk water by farmers, industrial users and town water suppliers from water resources managed by the Department of Natural Resources under the Water Administration Ministerial Corporation and the State Water Corporation. The IPART determination was released in September 2006.

### **Water licensing**

IPART is currently conducting a review of the Hunter Water Corporation's operating licence and expects to make its recommendations to the Minister in April 2007, with the new licence commencing on 1 July 2007.

IPART will also review State Water's operating licence during 2007, with the new licence applying from 1 July 2008.

At the end of 2006 the New South Wales Government introduced legislation to establish an access and licensing regime for the state's water industry. Once the *Water Industry Competition Act 2006* commences, it will provide for competition in the water industry. IPART will administer the licensing regime and make recommendations to the minister on applications for licences and access coverage.

### **Greenhouse gas abatement scheme**

This greenhouse gas abatement scheme (GGAS) aims to reduce greenhouse gas emissions associated with the production and use of electricity. It achieves this by using project-based activities to offset the production of greenhouse gas emissions.

Initially GGAS was to operate until 2012, but in 2006 the legislation was amended to extend this until 2021 or until a national emissions trading scheme is established to replace GGAS.

GGAS establishes annual state-wide greenhouse gas reduction targets, and then requires individual electricity retailers and certain other parties who buy or sell electricity in New South Wales to meet mandatory benchmarks based on the size of their share of the electricity market. If these parties, known as benchmark participants, fail to meet their benchmarks, a penalty is assigned. IPART monitors the performance of benchmark participants.

At 30 June 2006 there were 35 benchmark participants, 24 of which were compulsory participants, as prescribed in the legislation. Recent legislative amendments will extend the range of acceptable corporate arrangements for elective benchmark participants.

IPART also administers GGAS, accrediting abatement projects that reduce or sequester emissions. By March 2007 IPART had accredited 192 projects eligible to create certificates. To date, close to 40 million abatement certificates have been created by GGAS participants.

More certificates continue to be created than are needed for surrender by benchmark participants. However, abatement certificates are bankable—enabling those registered early in GGAS to be used for compliance in future years. In 2006 the scheme saw significant growth in projects involving the giving away of compact fluorescent lights and AAA-rated showerheads.

The abatement from these types of projects is claimed at the time of the appliance being installed, discounted to take account of the distribution method. During 2006 the abatement calculation factors in the relevant scheme rule were adjusted to reflect better information about the actual installation of these products by recipients. This has had the effect of reducing activity in this area.

Details of GGAS and abatement certificate providers can be found on the New South Wales greenhouse gas abatement scheme website ([www.greenhousegas.nsw.gov.au](http://www.greenhousegas.nsw.gov.au)).

### **Other reviews**

A the request of the New South Wales Premier, IPART undertakes reviews outside the utility regulation functions. Current reviews include:

- A review of the interface between the land transport industries and the stevedores at Port Botany (including vehicle-booking systems, rail access arrangements and other services to industry by, or in connection with, the stevedore business). Recommendations will be made on addressing issues materially impacting on the efficiency of the port-land interface. An issues paper inviting submissions is expected to be released in April 2007, with the review to be completed by the end of 2007.
- A review of the New South Wales registered clubs industry. This review will address the industry's role and performance, and will make recommendations in order to create a sustainable registered clubs industry for the future. The review will result in a management plan that will support and guide a sustainable registered clubs industry for a 10- to 15-year period. During the review, IPART will consider the role played by registered clubs and their contribution to the community, financial viability and corporate governance and development. An issues paper is expected to be released by May 2007.





## Tasmania

### Office of the Tasmanian Energy Regulator

#### Electricity Retail and Distribution Price Investigation

The current determinations of maximum prices for distribution services, certain metering services and retail tariffs provided by Aurora Energy Pty Ltd on mainland Tasmania are due to expire on 31 December 2007.

The Office of the Tasmanian Energy Regulator (the Regulator) has begun an investigation into Aurora's pricing policies for these services. This will be the last investigation into maximum prices for distribution services to be conducted under Tasmanian legislation before the economic regulation of distribution services is transferred to the Australian Energy Regulator under the National Electricity Law and the National Electricity Rules.

The purpose of the investigation is to determine maximum prices that may be charged by Aurora on mainland Tasmania for the following declared services:

- electricity distribution network services and metering services from 1 January 2008 to 30 June 2012
- retail tariffs and related services for non-contestable customers from 1 January 2008 to 30 June 2010.

The investigation's terms of reference require the Regulator to complete a draft report by 31 July 2007, with the final report to be completed by 28 September 2007.

Aurora's submission on the electricity distribution network and metering services proposes significant increases in both capital and operating expenditure. The Regulator has engaged independent consultants Wilson Cook to examine Aurora's proposals in more detail.

Aurora's submission on retail tariffs and related services proposes increased expenditure to meet the costs of operating in the National Electricity Market.

#### Energy price

The process for determining regulated tariffs for non-contestable customers from 1 January 2008 until the introduction of full retail competition uses a building-block approach, which requires separate inputs on the price of energy supplied by Hydro Tasmania or other sources, transmission charges, distribution charges and retail costs and margins.

The Tasmanian Government will set the energy price for 1 January 2008 to 30 June 2010 through amendments to the Electricity Supply Industry Price Control Regulations.

The price will be established through a process that includes the following steps:

1. Hydro Tasmania and Aurora Energy will agree on the non-contestable load parameters.
2. Hydro Tasmania will prepare a binding submission to the Treasurer on what it considers to be the market-based price for the non-contestable load, and will give an undertaking to abide by the Tasmanian Government's final decision.
3. An independent expert will provide the Tasmanian Treasury with a review of Hydro Tasmania's submission on the market-based energy price for the non-contestable load.
4. Treasury will recommend an energy price to the Treasurer, taking into account the outcome of the review by the independent expert.
5. The Price Control Regulations will be amended to incorporate the Government's decision on energy price as part of the building-block approach.
6. Hydro Tasmania and Aurora Energy will negotiate financial contracts for the blocks nominated by Aurora, in the context of the energy price established in the Price Control Regulations.

The Treasurer has requested the Regulator to report to him on the consultant's methodology and process (step 3) by 31 March 2007.

#### Distribution Network Reliability Standards

A joint working group of the Regulator, Aurora Energy and the Office of Energy Planning and Conservation has proposed new standards for electricity distribution reliability in Tasmania. These new standards will be incorporated into the Regulator's determination of maximum prices for electricity distribution services for 2008–12, as part of the service package Aurora is expected to provide for the revenue it is allowed.

Significant outcomes of the proposed new standards are:

- 'Urban' areas will increase from four (Hobart, Launceston, Devonport and Burnie) to 32, and will include significant regional centres. This will increase the number of electricity users in designated urban areas by 30 per cent.

- 'High density commercial' areas will increase from two (Hobart and Launceston) to eight.
- Approximately 30 000 customers will move to the new 'high density rural' classification, which has a significantly higher standard of reliability.
- A new area of critical infrastructure will be established in central Hobart.

The joint working group published a draft report in November 2006. It received a number of submissions in response to the report, all of which were broadly supportive of the proposed standards. A final report incorporating responses to the submissions and making final recommendations to the Regulator and the Tasmanian Government on the electricity distribution network reliability standards that should apply in the state was released in February 2007.

The Regulator and the Tasmanian Government will formalise the standards in either the Tasmanian Electricity Code or the regulations, depending on which is the preferred method.

#### Pay-as-you-go—cost comparison

The Regulator has released a comparison of Aurora pay-as-you-go costs with standard tariff costs based on 2007 rates. The aim of the comparison is to aid customers to make an informed choice as to which service offers more value to them.

The price comparison is based on a 'typical customer methodology' previously established by the Regulator. That methodology describes a set of 'typical customers' based on consumption patterns and the combination of tariffs from which they are supplied.

#### Reliability and Network Planning Panel reliability review

The Reliability and Network Planning Panel will submit its *Reliability Review Report* to the Regulator in early April 2007. The report assesses the outlook for reliability in the medium term (the next two years), supported by performance data for 2005–06 and, where available, trends over past years. The report draws on reports produced by licensees for the Regulator and includes observations and discussion on:

- several months' experience of physical interconnection of the power system to the National Electricity Market via Basslink
- the adequacy of Hydro Tasmania's management of the physical risks to Tasmania's electricity supply, including hydrological variability and the risk of Basslink failure



- the adequacy and performance of the transmission system and the impact of transmission security and planning criteria on the construction and maintenance of the transmission network
- the performance and underlying reliability of the distribution system, given Aurora Energy's reliability improvement strategy
- the introduction of new distribution performance standards
- electricity entities' emergency preparedness.

### Energy Supply Industry 2005–06 performance report

In December 2006 the Regulator released the sixth annual review of Tasmania's energy supply industry, including the first comprehensive review of the electricity wholesale market and trading patterns in the state.

### Performance and Information Reporting Guideline

The Tasmanian Electricity Code requires licensed entities to report on their performance by 30 September each year.

The Regulator published its *Performance and Information Reporting Guideline* in February 2007. The publication includes details of the Regulator's requirements for quarterly and annual performance reporting and the provision of complementary background information.

The guideline's key features are:

- reporting of general information, which cumulatively will provide the Regulator with an overview of the Tasmanian electricity supply industry
- reporting by licensees of progress in achieving their key goals and objectives as specified in their compliance and management plans, and reporting performance against agreed performance measures
- an analysis of past performance, projections for future performance and strategies in place to improve performance
- that each licensee's chief executive officer takes responsibility for information provided in annual performance reports
- updates on the progress of major capital works (i.e. whether key milestones and targets have been met).

The guideline's reporting requirements are consistent with national reporting requirements.

### Licences

The Regulator granted an application from Bell Bay Power Pty Ltd to amend its generation licence to increase the capacity of its three gas turbine units.

The Regulator granted a retail licence to Integral Energy Pty Ltd on 8 December 2006. Integral Energy is the first electricity retailer to be licensed in Tasmania since retail contestability was introduced in Tasmania in 2006.

These licences and the accompanying statements of reasons can be found on the Regulator's website ([www.energyregulator.tas.gov.au](http://www.energyregulator.tas.gov.au)).

### Code Change Panel

In September 2006 the Code Change Panel (CCP) consulted on an issues paper on proposed changes to the Distribution Powerline Vegetation Management Code. Those changes include making the Vegetation Management Code mandatory and amending the standards for the clearance of overhanging foliage.

In the same month the CCP also released its draft recommendations on a proposal from the Regulator to include a prepayment meter retail code in the TEC. The CCP's recommendations to the Regulator for the code's inclusion in the TEC can be found on the Regulator's website ([www.energyregulator.tas.gov.au](http://www.energyregulator.tas.gov.au)).

### Retail contestability update

The Electricity Supply Industry (Contestable Customer) Regulations 2005 give effect to the Government's policy in relation to retail competition. The regulations prescribe the conditions for the establishment of a contractual relationship where a fallback contract is deemed to apply.

A fallback contract will be triggered in prescribed circumstances, including where electricity is being supplied to a site but for various reasons there is no contract in place.

A retailer is required to submit a draft pro-forma contract for the Regulator's approval. The terms and conditions of the relevant draft pro-forma contract, including the price of customer retail services, are to be determined by the relevant retailer. For customers who consume more than 0.75 GW hours of electricity for the relevant qualifying period, the Regulator has a responsibility for approval in respect of two of the price related items—namely, 'Retail margin' and 'Other costs'.

In December 2006 the Regulator approved Aurora Energy's pro-forma fallback contract, proposed retail margin and other retail service costs.

The Regulator's final decision and a copy of the approved pro-forma fallback contract can be found on the Regulator's website ([www.energyregulator.tas.gov.au](http://www.energyregulator.tas.gov.au)).

## Government Prices Oversight Commission

### Bulk water investigation

The Treasurer has issued terms of reference for a Government Prices Oversight Commission (GPOC) investigation into the pricing policies of the three Tasmanian bulk water supply authorities (Hobart Regional Water Authority, Esk Water Authority and Cradle Coast Water).

Under the terms of reference, GPOC is required to complete a final report by 30 June 2007.

As well as the matters explicitly referred to under s. 31 of the *Government Prices Oversight Act 1995*, GPOC is also required to take into account whether the pricing policies adopted by the water authorities are consistent with the following water pricing principles:

- pricing regimes based on water consumption
- sustainable revenues to ensure that future cash flows are sufficient to meet operational requirements and asset replacement and future augmentation costs as they arise
- whether cross-subsidies, if they continue to exist, are transparent.

## Queensland

### Queensland Competition Authority

#### Rail

#### *Queensland Rail's 2006 access undertaking—activities and amendments*

The Queensland Competition Authority (QCA) approved Queensland Rail's 2006 access undertaking on 30 June 2006.

As well as establishing the negotiation framework for new access seekers, the access undertaking also requires Queensland Rail (QR) to systematically update aspects of the undertaking—including new reference tariffs, master planning and reporting requirements—on an on-going basis.



QR has produced a master plan to provide robust and transparent management of the future development of the central Queensland coal network. Consistent with the undertaking's requirements, the QCA:

- approved, in February 2007, the scope of 20 major capacity expansion projects, totalling \$583 million, in the central Queensland coal region for 2006–09
- will assess a request by the QR for approval of \$137.8 million-worth of capital expenditure on projects commissioned in 2005–06, once the QR provides additional information to support its claims.

QR has also proposed amending the approved undertaking to resolve an outstanding matter relating to QR's exposure to coal volume risk for the central Queensland coal network. QR has proposed moving from a hybrid price cap to a hybrid revenue cap. Its proposal outlines a detailed process to support this change, including amendments to take-or-pay arrangements and relinquishment fees.

The QCA received four submissions from interested parties in response to QR's proposal, and is now considering the issues raised in these submissions with a view to putting approved replacement arrangements in place by 30 June 2007.

Information about activities and amendments relating to the 2006 access undertaking are available on the QCA website ([www.qca.org.au](http://www.qca.org.au)).

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## Ports

### ***Dalrymple Bay Coal Terminal 2006 access undertaking***

On 15 June 2006 the QCA published its decision to approve the Babcock and Brown Infrastructure (BBI) access undertaking for the Dalrymple Bay Coal Terminal (DBCT).

Reflecting BBI's concerns about the regulatory risk of assessing the prudence of capital expenditure only after the works have been commissioned, the undertaking provides for certain aspects of the capital works to be assessed before commissioning. In particular, the undertaking provides for the QCA to assess prior to commissioning, among other things:

- the scope of the proposed expansion
- the standard and specification of the expansion works
- the works were contracted and managed in accordance with an approved tender process.

Since June 2006 the QCA has approved the scope of the terminal's planned expansions, the tender process for undertaking these works and the appointment of an independent external auditor to examine whether BBI has complied with the approved tender processes. The QCA has also approved the standard and specifications for contract packages valued at approximately \$500 million. This broadly represents two-thirds of all expansion costs expected to be assessed against the approved tender process.

The QCA will assess non-contract costs (e.g. finance, expansion design and management costs) once the expansions have been completed in line with standard regulatory practice.

BBI has also commissioned an incremental 'short gain' expansion of the terminal. The QCA anticipates that in the near future BBI will seek its approval to adjust the asset base and the annual revenue requirement to reflect the expansion costs incurred.

Copies of the QCA decision and the approved 2006 DBCT access undertaking are available on the QCA website ([www.qca.org.au](http://www.qca.org.au)).

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## Northern Territory

### **Utilities Commission of the Northern Territory**

#### **Standards of service report**

In November 2006 the Power and Water Corporation submitted its first performance report against minimum standards of service under the Northern Territory Standards of Service Code. The Utilities Commission published its assessment of the report in December 2006, acknowledging that there is scope for improvement in the quality of the data as well as a need to review the appropriateness of some of the minimum standards used.

#### **Annual power system review**

The Utilities Commission has released its 2006 annual review of trends in the adequacy and security of Northern Territory's power system. Although review focused primarily on conditions in the generation sector, it also discussed other matters being considered by the Northern Territory Government, including arrangements for power system planning and reliability in the Northern Territory and whether the NT electricity market should be subject to the national regulatory regime.

The review found that in the medium term it will be necessary to make decisions regarding the next increments to capacity, and that gas supply arrangements will continue to be stretched until the first supply of gas from the Blacktip field becomes available.

### **Review of the Northern Territory electricity regulation regime**

In July 2006 the Utilities Commission made a submission to a review on an optimal legislative framework for electricity supply in the Northern Territory. Deliberations are on-going, but are confidential at this stage and the Utilities Commission understands that no decisions on regulatory reform have yet been made. The Utilities Commission broadly supported adoption of national arrangements tailored to circumstances in the Northern Territory (rather than adopting national arrangements 'off-the-shelf' or implementing a specific Northern Territory regime that parallels selected arrangements in the National Electricity Market).

### **Generation pricing**

Following concerns raised by a contestable customer, an investigation by the Utilities Commission has revealed that the structure of Power and Water contestable electricity prices falls well short of being truly cost-reflective and gives rise to misleading price signals. This is primarily because Power and Water's retail prices:

- bundle together—rather than pass through—network tariffs with wholesale generation prices and a retail margin
- seek to recover these bundled costs by use of a coincident peak-pricing approach applied in conjunction with a fully-distributed costing methodology.

These result in contestable, load profile-dependent tariffs, with any substantial changes in load profile giving rise to revenue increments (decrements) unrelated to the impact upon the service provider's incremental costs and to instability in price component relativities between contract periods.

### **Unbundling of electricity retail prices**

In February 2007 the Utilities Commission began a compliance review of Power and Water's 'unbundling' of billing statements. The Utilities Commission will continue to encourage Power and Water to consider unbundling customer prices (into regulated and non-regulated components) at the time a contract is entered into as well as unbundling the resultant charges at the time of billing.

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# Contributing to *Network*

If you are interested in publishing an article in *Network*, contact Katrina Huntington:

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