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LEAD ARTICLE

2 - 7

The Use and Abuse of the 'Efficient Component Pricing Rule'
Rob Albon
ACCC

CRITICAL ISSUES IN REGULATION - FROM THE JOURNALS

8 - 15

INTERNATIONAL ROUND-UP OF REGULATORY DECISIONS

16 - 18

REGULATORY DECISIONS IN AUSTRALIA & NEW ZEALAND

19 - 27

NOTES ON INTERESTING DECISIONS

27 - 31

LEAD ARTICLE

The Use and Abuse of the 'Efficient Component Pricing Rule'

Rob Albon - ACCC

Introduction

If you want some idea or approach in regulatory economics to become famous, give it a catchy title including the word 'rule' – and, if you want that rule to sound inviolable; use the word 'efficient' as well. For a time in the 1990s it seemed there was never a regulatory discussion about access pricing where the **efficient component pricing rule** (ECPR) was not at least mentioned; often in a hushed reverent tone. Consequently, everyone wanted to show their sophistication, and strived to understand its basis and what seemed to many was its almost mystical power. However, for a number of reasons, reaching the ECPR nirvana was far from straightforward:

First, some of the biggest names in regulatory economics – William Baumol, Alfred Kahn, Jeffrey Sidak, William Tye, and Robert Willig – were involved in the debate. This is daunting enough in itself, but the difficulty was exacerbated by the fact that they were not necessarily singing the same tune, with opinion on the rule strongly divided.

Second, what appeared to be the same (or a very similar) rule kept on changing in name; the several alternative names reflecting either the claimed attributes or the names of its authors. The names used included 'optimal component pricing rule'; 'product component pricing principle'; 'parity principle'; 'Baumol-Sidak rule'; and 'Baumol-Willig rule'. While this may not have been clear at the time, these all pretty much mean the same thing. More recently 'retail-minus' has emerged as another synonym for the ECPR, or perhaps more accurately a re-branding', in circumstances where the retail price contains a monopoly rent element.

Third, there was ambiguity or lack of definition about what some very fundamental associated economic concepts mean – particularly 'incremental cost'; 'opportunity cost' and 'efficiency'.

The discussions culminated in a number of major debates towards the mid-1990s – *inter alia* in the prestigious *Yale Journal on Regulation* and in the context of telecommunications access pricing in New Zealand. While the results of these debates appeared to have put the ECPR to rest *circa* 1995, it never really went away. And while some of the claims of its proponents proved in the event to be cavalier, an understanding of the ECPR can help in appreciating the various tricky issues surrounding providing access to competitors relating to, *inter alia*, allocative efficiency; funding the universal service obligation; and contributions to common costs. The ECPR provides a useful framework for thought about these issues, even if its strict application does not actually provide an efficient outcome in the typical circumstances of access to essential facilities.

The purpose of this paper is to provide a brief history of the origins of the ECPR, to exposit the rule as set out by its proponents (William Baumol, Robert Willig and Jeffrey Sidak), to assess its interpretation by others, and to review its application and applicability in a number of areas – particularly rail, telecommunications, post and water.

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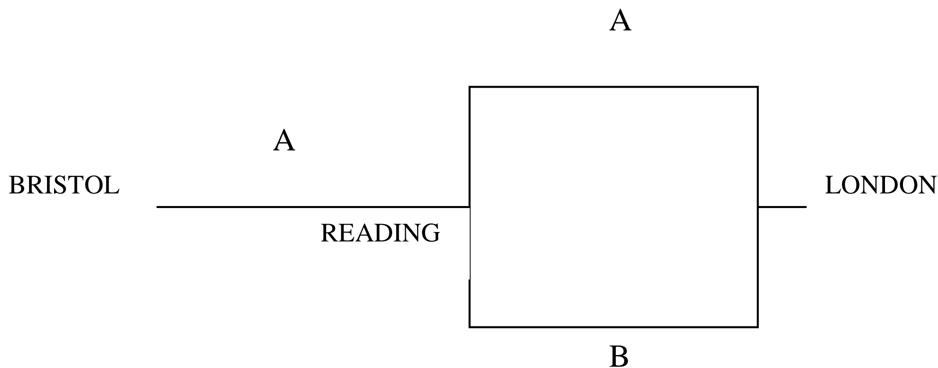
Origins and Exposition of the ECPR

The well-known American economist, William Baumol, developed the ECPR in relation to railways (access to rail track) in the 1960s and 1970s and then applied it in telecommunications (with co-authors Robert Willig and Sidak) in the 1980s and 1990s. In all relevant regulatory cases Baumol advised the incumbent subject to the prospect of entry by a competitor wanting to use its facilities – and unable to agree on price. The incumbent sought to charge a price that did not threaten its pricing of the final good (a 'monopoly price') while the access seeker sought to pay a lower price based on 'cost' somehow defined. The asking and offer prices were usually a long way apart.

Because Baumol was often associated with defence of incumbency, the ECPR was widely interpreted as a defence of monopoly retail pricing through including a compensation for lost monopoly profits as a consequence of an access seeker's competition in downstream markets. Baumol was also often interpreted as seeking to justify the monopoly price on 'efficiency' grounds. Initially the proponents of the ECPR were either silent on this or stated that it was not intended for this purpose – it was 'efficient' because it allowed the seeking out of operators of a production component that could supply that component at lower cost. Access seekers began to employ their own experts to argue for cost-based pricing and to question the analysis of Baumol and his collaborators. The ECPR began to be seen in a new light. Before exploring this further it is necessary to exposit the rule in the framework always used by Baumol.

Most expositions of the rule use a stylised railway example. Baumol (1995) discusses a case where a party A operates a railway business between Bristol and London with two components, Bristol to Reading and Reading to London. Another railroad operator (B) serves the link only between Reading and London, but wishes to expand its service to provide a complete Bristol to London link by renting 'trackage rights' on A's Bristol to Reading segment.



Baumol (1995,[1] page 273) then defines the **efficient component pricing rule** for access to the Bristol-to-Reading track as follows:

Component price = direct per unit incremental cost of the component supplier
+ its per unit opportunity cost

Common to all Baumol's work on the ECPR, the **incremental cost** is defined on a long-run basis, not a short-run basis. Explicitly, Baumol (p. 274) defines it as including

> … the required profit on any required incremental investment, that is, the cost of the required capital.

[1] This paper was published in 1995 but was circulating several years earlier, possibly from about 1990, as a mimeo. Some passages are similar to Baumol and Willig (1991).

The other key cost concept, **opportunity cost**, is defined (p. 273) as follows:

> … the incremental opportunity cost its traffic imposes upon A: the loss of …contribution [toward its fixed and common costs] that A incurs for every ton of business that B is enabled to take away from A by its use of A's tracks.

It is important to consider this opportunity cost in relation to the degree of substitutability between the rival's service and that of the incumbent, which determines the 'displacement ratio' of the incumbent's offering. Baumol's standard exposition unreasonably implies a 100 per cent displacement, but real-world impact will often be much less. Where entry competes away the monopoly profits, the access provider would receive a price to cover its costs inclusive of a normal rate of return on the remaining downstream assets. An adjustment path on the access price may be required in recognition of sunkenness of some assets used in downstream production. Adjustment to the new level of downstream output can only reasonably be made in the long run.

Baumol does not mention explicitly foregone monopoly profits in this particular exposition but the standard interpretation is that anything between incremental cost and price of the final service is part of the opportunity cost. In other expositions – such as the Baumol and Willig (1991) consultants' report for New Zealand Telecom – monopoly profits are mentioned, but any role of the ECPR in relation to them is expressly ruled out, *viz* (page 37):

> … efficient component pricing does not , and is not designed to, cure mispricing of any other items handled by the firm in question. For example, … [it] cannot be used to deal with any overpricing of final product that is alleged to be present. Any problems in such domains should be attacked with different tools.

Baumol and Willig also discuss issues surrounding cross-subsidisation, where the granting of access could reduce the ability of an incumbent to tax end users. This issue is considered briefly below.

What is meant by 'Efficient' in ECPR?

One of the keys to understanding the ECPR is to check how the word 'efficient' is being used. It is necessary to look out for implicit or explicit references to 'productive efficiency' (relating to minimising cost of production) and 'allocative efficiency' (relating to deviation of price from cost).

In the original discussions, the word 'efficient' in the ECPR is a reference to productive efficiency. As Baumol (1995, page 273) puts it:

> … economic efficiency requires that the competitive segment of the service be performed only by efficient suppliers … whose real costs … are the lowest available'.

So if the rival could supply the competitive component at a lower cost than the incumbent, *and* if it were to charge the same retail price for the final product, it could enter profitably. Realising this limitation saves a lot of confusion. If this thing had been called the 'productively-efficient component pricing rule' everyone would have been that much wiser about the ambit of the claim being made.

However, this would preserve in place any existing monopoly pricing. That is, the ECPR does not serve the cause of allocative efficiency at all. This point was made by economists acting for access seekers in these regulatory cases. Thus, William Tye (1994, p. 210) successfully argued that Baumol and Sidak had by

> means of semantic devices … [translated] monopoly profits into incremental costs and opportunity costs
>
> Baumol and Sidak in their 'Rejoinder and Epilogue' (p. 178) did not accept Tye's contention, but nonetheless included a second efficiency requirement that, in addition to the … [ECPR], final product prices must be constrained by market forces or regulation so as to preclude monopoly profits.

All expositions of the ECPR by Baumol and his collaborators commencing in 1994 include an **assumption** that the ECPR price does **not** include a compensation for lost monopoly rents. Then, in 1996, Baumol (together with Janusz Ordover and Robert Willig) observed (paragraph 22) in the context of US telecommunications that:

> … applying ECPR to the existing rate structure would result in component prices that lock in the ILEC's monopoly profits and inefficiencies … ECPR was never intended to (and cannot) substitute for competition … or limit to fully competitive levels the prices paid by end users for services that use those network elements.

Prior to the debate in the *Yale Journal* (including especially the criticism by William Tye), Baumol had never included this proviso, but he had recognised that the ECPR would not play a constraining role on monopoly pricing.

Cross-Subsidisation

Consideration of the opportunity cost of providing access leads to the identification of three possible contributions that could come out of the difference between price of the final service and the long-run incremental cost of providing access. These are contribution to the incumbent's (i) overheads (or common organisational-level costs); (ii) monopoly profits; and (iii) taxation revenue to fund subsidies elsewhere in the form of pricing below long-run incremental cost ('cross-subsidisation').

While there can be no presumption that the subsidy should be funded from a tax on access, the use of the ECPR does focus the mind on this funding issue. To the extent that entry results in a diminution of taxation revenue used to fund a subsidy elsewhere, attention is drawn to alternative ways of funding it – and to the rationale of the subsidy in the first place.

How has the ECPR been applied?

New Zealand Telecommunications

The ECPR was intensely debated in New Zealand in the early 1990s when an attempt was made by New Zealand Telecom to apply it with respect to access to its fixed-line network by its rival, Clear Communications. Economists including William Baumol, Alfred Kahn, William Tye and Robert Willig were all directly engaged in the New Zealand debate; Baumol and Willig (1991) on behalf of New Zealand Telecom. In the event the use of the ECPR was sanctioned by the Privy Council in *Telecom v Clear*, when it decided that charging on such a basis does not constitute use of a dominant position under s.36 of the Commerce Act (see Pickford, 1996). This decision was perhaps the greatest success of the ECPR. However, later the use of the ECPR in New Zealand was explicitly ruled out in the new telecommunications legislation of 2001.

Australian Telecommunications: Incompatibility with Part XIC Legislative Criteria

The current legislative criteria state that in determining the reasonableness of any terms and conditions, the ACCC must have regard to, amongst other things, direct costs of providing access to the declared service concerned. With regard to direct costs, the Explanatory Memorandum to the Act states:

> ...'direct' costs of providing access are intended to preclude arguments that the provider should be reimbursed by the third party seeking access for consequential costs which the provider may incur as a result of **increased competition** in an upstream or **downstream market**. [emphasis added]

Any loss of 'value' argued for by an ECPR methodology (or any similar methodology) appears to be directly in contradiction with the above statement as such an argument is precisely that which is intended to be precluded by the direct cost criterion.

The ACCC's previous practices of adding an access deficit contribution to the fixed-line access (public switched telecommunications network origination and termination or 'PSTN OT') price and the retail-minus approach to local call resale (known as 'local carriage service' or 'LCS') are *not* examples of the application of the ECPR. In the case of LCS the retail-minus approach was in recognition that the retail price of local calls was capped under the retail price controls, and that the price did not meet the costs of provision as assessed by the ACCC's TSLRIC methodology. Given that the ACCC's assessment of the criteria concluded in favour of subjecting local calls to access, the retail-minus approach was considered as a reasonable approach that would not directly damage Telstra's existing financial position.

Australia Post: Discount off Standard Letter Price by Access Seeker's Own Provision (e.g., sorting)

King and Maddock (1996, pp. 150-151) interpret a pricing discount applied by Australia Post as an application of the ECPR.

> Australia Post estimates the cost-saving achieved by user-provided sorting or transport, and discounts the 'full' price accordingly. … This avoids inefficient entry … since any new entrant must provide some part of the service more efficiently than the incumbent.

Whether this is truly the ECPR would depend on how the discount is calculated. This may be one instance where an incumbent would want to apply short-run marginal cost.

Survey by UK Competition Appeal Tribunal

In its Judgement on Albion Water's appeal the UK Competition Appeal Tribunal (2006) reviewed the international and national contexts of suggested examples of the use of the ECPR. This review, covering over 40 pages, included the New Zealand telecommunications issue discussed above and a number of US and UK examples. Its conclusion on the ECPR in general (paragraph 738) was as follows:

> The evidence before the Tribunal is to the general effect that ECPR is in fact a controversial methodology, both in the academic literature and as a matter of regulatory practice, a fact that is not referred to in the Decision. The NERA reports, referred to in paragraphs 321 and 322 of the Decision, and prepared for Northumbrian Water, do not in our view fully bring out the extent of that controversy. We have been provided with no examples or case studies of ECPR being successfully used.

Further, the Tribunal rejected the use of the ECPR in the *Albion* case as being 'not a safe methodology' (paragraph 835) and as 'eliminating existing competition and preventing virtually any market entry' (paragraph 836).

Conclusions

The debate over the ECPR has been long and circuitous, with confusion over its objectives and the definition of key economic concepts. The implicit or explicit objectives of applying it have encompassed, *inter alia*, productive efficiency, allocative efficiency, and USO funding. Debates in the mid-1990s served to clarify these issues substantially.

Baumol is said to have quipped that the ECPR 'was never intended as a cure for baldness'. However, owing to Baumol's association with incumbency and the lack of clarity surrounding key aspects, the ECPR was widely interpreted as a defence of monopoly retail pricing by incumbents through allowing inclusion of compensation for monopoly profits lost as a consequence of an access seeker's competition in downstream markets, and the seeking of a justification for this on 'efficiency' grounds. The proponents of the ECPR were either silent on this or stated that it was not intended for this purpose – it was 'efficient' in the sense that it allowed the seeking out of operators of a production component that could do it at lower cost. However, following the critiques by Tye and others, Baumol began to present a second (allocative) efficiency rule aimed explicitly at addressing incumbent monopoly. This made things much clearer.

Rather than seeking a universal 'rule', the fundamental lesson from this saga is to be thorough and explicit in our approach to access pricing. It is in this context that Tye concluded his critique of the ECPR by pointing out (p. 224) that:

> [t]here is no substitute for a careful assessment of the regulatory goals and institutional circumstances on a case-by-case basis to determine the economically efficient approach for pricing of competitive access.

The ECPR framework helps in sorting out the issues to be considered in making this assessment.

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Future Direction in Railway Management and Regulation

Nick Wills-Johnson *Planning and Transport Research Centre Working Paper Series*, Working Paper No. 8, October 2006

This article is concerned with the economic regulation of Australia's railways and the potential for changes to the regulatory framework that currently governs the railway sector. The articles key points are that the standard neoclassical approach to regulation of rail misses some of the crucial elements of railway competition, in particular that competition happens on a transport network. If rail is correctly incorporated into the logistics chain, then a different, less intrusive, approach to regulation may be appropriate.

The paper starts with a discussion of the differences between railways and other utilities. Taking account of these differences means that the standard neoclassical model of economic regulation is problematic when applied to railways. First, the author notes that the physical shape of the railway network is important to the economics of the industry particularly where there is intermodal competition. The author observes that the study of locational effects on competition has a long history but little of this has been applied to regulatory economics, particularly in relation to transport regulation. Secondly, Wills-Johnson points out that the problems of information asymmetry, second best and regulatory risk all have consequences for the standard regulatory framework.

Wills-Johnson elaborates on the behaviour of competition in networks, noting that the physical shape of the network can influence competition in two ways: first, it provides a framework by which competition occurs more strongly between those located near each other than between those located at a distance while still allowing for prices to be transferred through the network through a process of bilateral competition; and secondly it can provide a framework where competition occurs on the basis of networks of strategic assets in the overall transport network including the broader logistics industry. The shapes of the companies on this network of assets can provide clues as to the exercise of market power.

The author uses two examples to explain his view that larger welfare gains may be achieved by stepping outside the confines of neoclassical economics.

The first example relates to cost allocation and coal chain pricing. Wills-Johnson argues that a catch-22 arises in relation to sunk cost investment that might not be fully utilised because of a fundamental externality in the coal chains arising from information asymmetry between the railways and the mines. This externality is best addressed by finding ways for the mines and railways to make credible commitments to each other about funding for future infrastructure, not be economic regulation that focuses on introducing above-rail competition.

Secondly, Wills-Johnson suggests that efficient prices might be achieved using notions from game theory, in particular fairness. Notions of fairness may be of practical interest because fair treatment is crucial to successful contracting. Incorporating the Shapley value into contracts involving asset investment by both above and below rail operators, for example, may be a useful and different approach to standard regulatory ones.

Do Consumers Switch to the Best Supplier? Chris Wilson and Catherine Waddams Price, *Centre for Competition Policy, University of East Anglia,* CCP Working Paper 06-2007

This paper is an update of the paper presented by Professor Waddams Price at the ACCC's 2006 Regulatory Conference.

Policy makers are placing increasing emphasis on the positive role that consumers should play in generating market competition by the choices they make. If there are sufficient retailers and consumers are able to respond rapidly to competitive offerings by switching suppliers, it may be possible to reduce regulation at the retail level. Consequently there is increased interest in the barriers that affect consumers' ability to switch supplier.

It is well known that consumers' ability to switch may be hindered by switching, search and cognitive decision-making costs. Most of the existing literature has concentrated on the impact of switching costs.

This paper examines the importance of search and cognitive decision-making costs in the UK context. It analyses the accuracy of consumers' switching behaviour insofar as they choose (or do not) to switch to a lower cost supplier. Contrary to expectations, the authors' findings show that significant numbers of UK consumers are switching to ***higher*** cost suppliers, suggesting that complexities in the market create consumer detriment and prevent the market from working well. Furthermore, despite the opportunity to switch to a cheaper supplier around 50% of electricity consumers have stayed with their incumbent supplier. The authors consider that while some of their findings are consistent with high search costs, the most consistent explanation is that consumers made poor decisions.

The authors conclude that consumers may not be able to take advantage of the savings on offer to them. This may be the result of tariff complexity. If so, there may be a need to improve the pricing information that is available to consumers. The authors also question whether the extent of choice in the market is in fact acting as a barrier to consumer switching and may instead reaffirm the market power of incumbents.

Growing Pains: FERC's Responses to Challenges to the Development of Oil Pipeline Infrastructure
Christopher J. Barr, *Energy Law Journal,* 28 (1) 2007

This paper provides an overview of the Federal Energy Regulatory Commission (FERC)'s approach to regulatory issues relating to the development of oil pipeline infrastructure in the US. The US oil pipeline industry is not subject to the same degree of regulatory or public scrutiny as gas and electricity transmission. Nevertheless, it faces critical regulatory issues that can affect the viability of new pipeline proposals.

The paper describes the evolution of the regulatory setting for oil pipelines in the US. The FERC is required to implement a simplified and streamlined form of regulation under the *Energy Policy Act 1992*, which determined that most existing rates were just and reasonable. Consequently, rate changes for existing pipelines were made subject to a generic oil pipeline 'index ceiling'. However, some regulatory risks remain: in particular (1) standards for challenging 'grandfathered rates' and; (2) tax allowance for the partnership and related corporate forms. Rulings made by the FERC have provided some clarity. However, those rulings are currently subject to judicial review so that uncertainty remains.

For new pipelines or pipeline expansions, the FERC must determine whether the terms and conditions of service are reasonable and non-discriminatory. It also enforces the pipeline operator's obligation to accept requests for transportation on reasonable request. Therefore, a critical issue for new investment is the terms and conditions under which transportation will be supplied.

One of the key issues for new investment has been an absence of a power to pre-approve prices, terms and conditions. This has generated considerable uncertainty and risk for new investment. In the past decades, FERC has taken a number of steps to address these issues to minimise the risk that they may deter investment. For example, although the FERC has made increased use of declaratory orders and pre-emptive settlement offers for advanced approval of key rates and tariffs in order to provide the certainty that may be necessary to obtain funding for investments.

In addition, the common carrier status of oil pipelines has increasingly impacted on investment decisions. The FERC has adapted to changing industry circumstances by accepting broader, more equitable, capacity preferences.

The author concludes that the FERC has taken steps to reduce uncertainty and risk for new oil pipeline investments. However, in a changing industry environment, it will continue to face the challenges to minimise the risk that its regulatory approach may deter necessary investment.

Regulatory delay and the timing of product innovation

James E. Prieger, *Department of Economics, University of California;* April, 2007

Prieger tests the theory that reductions in decision making times by regulators causes regulated firms to speed up the introduction of new products. A simple theoretical model is presented which provides a rationale for such decision making by regulated firms. This model is then tested empirically using a data set on new product introductions by a Bell Operating Company in four Midwestern states in the US from 1991 to 1999.

The time between product feasibility and lodgement with regulators for approval is defined as ‘introduction delay,’ while the time taken for regulators to make a decision is defined as ‘regulatory delay’. Prieger suggests a simple model that describes a potential multiplier effect from regulatory delay; a greater regulatory delay induces regulated firms to choose a longer introduction delay.

The model assumes the opportunity cost of a given increase in regulatory delay is the discounted future profits from the new product. This opportunity cost of introduction delay is lowered when regulatory delay increases, because the discounted future profits become smaller. At the same time, the fixed cost of introduction is assumed to be falling through time due to exogenous technological factors, so there is a marginal benefit from delay. In response to an increase in regulatory delay, which lowers the opportunity cost of introduction delay, the firm choses a later date that equates the lower marginal cost with the lower marginal benefit. Or conversely, when regulatory delay is reduced, the opportunity cost of introduction delay becomes larger, for which a higher marginal cost (earlier introduction date) is justified.

The empirical findings fail to reject the hypothesis that a regulatory multiplier effect existed in the data examined. Controlling for state-specific and other factors, Prieger is able to draw the conclusion that the reduction in average regulatory delay among the states during the period contributed toward speedier product introductions by the Bell Operating Company in those states. The paper concludes that to the extent that excess regulatory delay exists, the additional social cost of delay from distorting the incentive to create and introduce new products should be factored into regulators’ and legislatures’ social calculus.

Introducing competition and deregulating the British domestic energy markets: a legal and economic discussion

M. Harker and Catherine Waddams Price, Centre for Competition Policy, University of East Anglia, CCP Working Paper 06-20 2006

This paper provides an overview of the development of competition in and deregulation of the British retail energy markets. During the deregulation period *ex ante* price controls were gradually replaced by *ex post* policing of pricing practices under the general competition law. The sectoral regulators were granted the power to apply the general competition law, in particular the Chapter II prohibition governing abuse of dominance, to specific industry sectors.

The paper describes the evolution of competition in the deregulated market. Two competitive constraints, the ability of consumers to switch suppliers and the threat of entry, seem to be too weak to effectively constrain the incumbents from abuse of market power and engaging in coordinated behaviour. Relatively high switching costs make it costly for consumers to change suppliers. While some switching has occurred, incumbents have retained significant market shares with substantial mark-ups over entrants. The authors consider that the six incumbent firms have developed collective dominance.

As a politically-sensitive sector, the energy industry has traditionally adopted a uniform pricing system with cross-subsidises among consumer groups. The recent exposure to competition makes such a pricing system unsustainable, leading to a distributional impact that is socially undesirable.

Relying heavily on competitive forces, the regulators seem to be less concerned with the incumbents' moves to rebalance their prices. Ofgem claimed that it had been vigilant in preventing dominant firms from engaging in pre-emptive behaviour, in particular, predatory pricing. However, the issue of price discrimination has not been adequately addressed by the regulator. Using the avoidable costs test, Ofgem failed to find any evidence of undue discrimination in the case of BGT that offered a price discount to its direct debit customers.

While case decisions made by the regulators largely follow the principles derived from the general competition law, it has created a degree of uncertainty over what is a legitimate response to competition on price by an incumbent in a deregulated market. The authors argue that *ex post* policing is not necessarily superior to *ex ante* regulation. As a substitute for the general competition law, *ex ante* regulation may bring greater certainty in the application of the law and reduce the costs of regulation.

The authors conclude that the outcome of the deregulated British retail energy markets is ambiguous. The recent sharp rise in real energy prices and the incumbents' continuing market power suggests that deregulation may have failed to protect low-income households.

Worksharing, Access and Bypass: The Structure of Prices in the Postal Sector

E. Billette de Villemeur, H. Cremer, B. Roy, B. and J. Toledano *Journal of Regulatory Economics* 32: 67 – 85 2007

This paper studies potential market equilibria in a liberalised postal market where a regulated incumbent with universal service obligations competes with non regulated entrants. A model is developed that provides optimal pricing rules given general demand and allows the possibility of access, bypass, consolidation and worksharing. The model allows entrants to offer either end-to-end products or to concentrate on one segment of the market.

Absent effective bypass, entry does not appear to be a serious financial threat to the incumbent, even when the products are perfect substitutes. However, the authors show that when bypass is possible, a wide variety of scenarios can emerge depending on the regulatory environment and on the relative cost and demand structures for the incumbent and the entrants' products. Some of these scenarios threaten the incumbent's financial viability.

For instance, if the entrant is able to offer cheaper service in delivery, the incumbent may lose the entire pre-sorted mail market and be left with household demand and demand from firms with high preparation costs. Since the remaining market segments are likely to be low volume, the incumbent's revenue may no longer be sufficient to cover its fixed costs. This would threaten the incumbent's ability to provide the universal service.

The authors conclude that the threat of bypass is strongest if the incumbent is prevented from discriminated between customer groups, or is subject to some form of uniform pricing. Allowing it more pricing flexibility may increase welfare and mitigate the threat that bypass poses to its survival.

Regulating a Multi-Utility Firm

Giacomo Calzolari and Carlo Scarpa*, Centre for Economic Policy,* Research Discussion Paper #6238, 2007

This paper studies the optimal form of regulation for a utility which operates in both competitive and regulated markets and enjoys economies of scope in the production of goods for those markets.

The institutional response of regulators to the horizontal integration of regulated and non-regulated services has often been to operationally separate the assets and personnel pertaining to the two sectors. The motivation for this has been twofold.

First, a regulator wishes to limit the extent of asymmetric information about the production costs of the regulated firm. Secondly, regulators often perceive that regulated firms that operate in unregulated markets have a competitive advantage over firms which do not. Specifically, there is a concern that a regulated utility could transfer some of the costs from their unregulated activities to their regulated activities and predatory price in the competitive market.

The authors' analysis examines the desirability of allowing a regulated utility to exploit joint economies of scope in production. They assume in all cases that the utility's economies of scope in production are always genuine. In their results, the authors' find that there is a trade-off in allowing a regulated firm to exploit economies of scope. Integrated production reduces the costs of services, which will be at least partially passed on to lower prices, so that consumers (possibly in both markets) should benefit. The downside is that the regulated utility's private information about its costs makes the regulator's task more difficult and thereby distorts regulatory policy.

Potentially, competition in the unregulated segment can also be affected. The paper assumes that the regulatory distortion and effects on competitiveness in the unregulated market are proportional to the economies of scope in production. Given this assumption, the authors are able to show that integrated production by the regulated utility is socially optimal. Lastly, the authors' note that regulatory distortion associated with joint production across regulated and competitive markets is substantially lower under quantity as opposed to price competition.

European Sector Regulation and Investment Incentives for Broadband Communications Networks

Harald Gruber*, European Investment Bank.* March, 2007

This paper looks at the relationship between regulation and investment in the European Union broadband telecommunications sector. It argues that cost-based access pricing regimes, although successful in attracting new entrants, have negatively affected investment in fixed-line infrastructure. Some aspects of access regulation, such as local loop unbundling, seem to have become substitutes for, rather than complements for, investment by new entrants. Furthermore, regulated prices for existing infrastructure penalises the development of alternative technology platforms. In comparison, access regulation is much less intrusive in the mobile telecommunications segment where there is a higher level of facilities-based competition. There, investment levels have decreased much less and there is closer alignment of market shares with investment shares.

The paper starts by discussing the evolution of telecommunications regulation in the EU. Gruber contends that after almost a decade of sector liberalisation in the EU, the economic and financial performance of the telecommunications sector is unsatisfactory. This is despite reforms that are intended to induce investment by entrants and improve access to capital for incumbents.

Gruber argues that the way access prices are determined can have a strong impact on both the types of entry and the incentives for investment. He contends that access prices based on forward looking incremental cost provides clear advantages for entrants. These advantages reduce the incumbent's incentives to invest in new infrastructure. However, according to the 'ladder of investment' theory which permeates European access regulation, new entrants will eventually invest in their own infrastructure, thus reducing the negative impact of reductions in the incumbent's investments.

Gruber tests the ladder of investment theory by noting that if access prices provide appropriate incentives for investment, then one should observe a decrease in the market share of access lines for resale and bit-stream access paths, while shared access and ULL should increase over time. In this regard, he presents figures which show increasing facilities-based competition. However, he asserts that there is very little overall investment and that new entrants in particular display a poor level of investment compared with their market share. This is consistent with the notion that access prices are too low so that incumbents have little incentive to invest and entrants have little incentive to replicate their rented assets. This slows down the diffusion rate for broadband access.

According to Gruber, the key to restoring investment incentives would be to modify the regulatory environment to encourage true platform competition. Regulatory holidays could be an option. However, Gruber recognises that reducing access regulation in the fixed-line sector may require a country-specific approach as there are important differences across countries.

Efficiency Trade-Offs in the Design of Competition Policy for the Telecommunications Industry,

Philip Gayle and Dennis Weisman *Review of Network Economics,* No. 6, 3, September 2007

This paper analyses the balance between static and dynamic efficiency in designing competition policy for the US telecommunications industry.

The authors examine the Federal Communications Commissions policy evolution on network unbundling and pricing in implementing the 1996 U.S. Telecommunications Act. Over time, the FCC recognised the trade-off problems associated with its original policies governing network unbundling and pricing. The paper notes that excessive network unbundling requirements might reduce the incentives to invest in networks, while the application of TELRIC pricing might discourage facilities-based entry. The authors note that the FCC has gradually moved to a more balanced approach, by narrowing the set of unbundled network elements (UNEs) and re-evaluating the TELRIC pricing.

Gayle and Weisman point out that policy analysis regarding innovation in the telecommunications industry has neither distinguished between process and product innovation nor separated the effects of mandatory unbundling from those associated with the pricing of UNEs. Their paper uses a two-stage game to model the respective effects of unbundling and pricing on process innovation.

They also find that investment in innovation increases when network unbundling obligations are relaxed. In addition, investment in innovation is shown to decrease with the UNE prices within the range of prices that preserve the entrant's efficient make-or-buy decision.

It is demonstrated that when UNEs are priced so as ensure efficient make-or-buy decision from the entrant in the short term, mandatory unbundling lowers the incumbent's incentive to invest in the longer term. The paper suggests that it is the mandatory unbundling policy rather than low UNE prices policy *per se* that reduces the rate of process innovation, leading to reduced dynamic efficiency.

The authors conclude that it is important for future policy analysis to make a distinction between the effects of mandatory unbundling and the effects of UNE pricing on investment in innovation.

The Arguments For and Against Ownership Unbundling of Energy Transmission Networks;

M. Pollitt, *Cambridge Working Papers in Economics No.0737,* August 2007

The paper presents theoretical arguments, empirical evidence and case study evidence to evaluate the costs and benefits of the unbundling of energy transmission networks. The paper concludes that evidence suggests that the ownership unbundling of transmission networks is a key part of energy market reform in the most successful reform jurisdictions.

The discussion includes: the theoretical effects on competition; ease and effectiveness of regulation; the facilitation of privatisation; the security of supply; transaction costs of unbundling; the cost of capital; synergy/focus effects; double marginalisation; the effect of foreign takeovers; and the reduced risk of arbitrary government intervention. The paper judges that these effects are generally positive in favour of ownership unbundling. However, the reorganisation costs of the ownership unbundling process may offset the benefits.

The paper also summarises some empirical evidence on whether the models that assume the transmission networks are unbundled are better than others. Politt notes that the econometric evidence is weak due to the fact that, in many jurisdictions, other reform steps such as the restructuring of generation or production markets, privatisation etc. often occurred at the same time as ownership unbundling of transmission networks.

The paper finally presents case-study evidence which suggests that unbundling the ownership of transmission networks is a key part of energy market reform in the most successful reform jurisdictions.

Implications of Network Convergence on Local Access Regulation in the US and the EU

M. A. Vanberg*, ZEW Discussion Paper No. 07-039* Manheim, June 2007

This paper discusses the development of telecommunications regulation in the US and the EU, and, in particular, on how regulation has adapted to deal with the convergence of telecommunications services. The central conclusion of the paper is that despite liberalisation policies being introduced in the US and the EU at roughly the same time, the regulatory approaches have differed substantially: deregulation in the US has gone too far, while the tendency in the EU has been toward overregulation.

The paper identifies a number of positive and negative aspects of each approach. In the US the positive aspects include: a close alignment of unbundling policies with the 'essential facilities' doctrine; a policy focus on investment incentives and infrastructure competition; and the approach of forbearance. The negative elements include a tendency for decisions about the scope of regulation to be dictated by political considerations, and an insufficient focus on policies that might enhance infrastructure-platform competition. In the EU, the positive aspects identified include: policies which are closely aligned to competition law concepts, and better management of spectrum allocation issues, while the principal negative aspect identified is the misapplication of the EU regulatory framework resulting in the *ex ante* regulation of more activities than necessary.

The implications of the paper are that some 'next generation services' in the US, such as broadband access in areas where no viable competition exists, should be subject to greater levels of regulation. Conversely, in the EU the list of activities which have been identified as potentially subject to *ex ante* regulation should be reduced to account for potential substitution possibilities among services.

INTERNATIONAL ROUND-UP OF REGULATORY DECISIONS

Argentina – Competition regulator investigates Telecom Argentina - Article

Argentina's competition regulator, National Commission for the Defense of Competition (NCDC), is investigating the impact of Telefonica SA's purchase in Telecom Italia on local operator, Telecom Argentina. NCDC is concerned that the overlapping markets will create antitrust issues as Telecom Italia owns a 50 per cent stake in the Telecom Argentina's holding company (Sofora) and Telecom Argentina's main competitor is Telefonica's Argentine unit (TAR).

**Canada – CRTC publishes findings on media consolidation - ** Article

Canada's broadcast regulator, the Canadian Radio-Television and Telecommunications Commission (CRTC) has published its review of the broadcasting industry recommending less regulation, more competition and consumer choice. The CRTC is considering changing consolidation rules to resemble the Australian regulatory model.

**China passes first anti-monopoly law - ** Article

After a decade of speculation, China's much-anticipated Anti-Monopoly Law was recently passed. The new law is aimed at preventing companies setting up monopolies and abusing dominant market positions although a competition regulator will not be established to enforce the legislation. The legislation will require foreign companies to undergo comprehensive economic and security checks if they wish to merge with Chinese enterprises.

EU – European Parliament votes on liberalising EU postal markets – Original Decision

The European Parliament has voted in favour of opening up European postal markets to increased competition through the dissolution of existing monopolies by December 2010. National operators will no longer be able to have a monopoly over mail below the maximum weight limit of 50 grams, known as the reserved area. The new regime, anticipated to begin in most states by 2011, will retain universal service (nationwide delivery, five days a week also known as territorial coverage) to maintain affordability of postal services in the EU.

EU – EC proposes superagency to monitor roaming - Article

There is continuing discussion that the European Commission is considering a plan to create a superagency: the European Telecom Market Authority, with power to override national telecommunications regulators and open up domestic markets to competition. The plan is scheduled to be presented to Commissioners in November 2007 and if the proposal is endorsed will be forwarded to the European Parliament for final approval in 2008.

**EU – EC announces 'third energy package' reforms - ** Article

The European Commission has announced sweeping reforms to the energy sector focusing upon the unbundling of distribution networks by integrated power groups who dominate the sector . The reforms titled the 'third energy package' are designed to boost competition and promote the creation of a common European energy market.

India – ASEAN to create regional energy grids - Original Decision

At a recent ASEAN Energy Ministers' meeting, it was announced that ASEAN will form a regional power grid in which its ten-member nations will trade electricity and gas under a series of harmonised rules and regulations. ASEAN representatives also expressed a desire to reinstate an action plan to create an A$8.6 billion Trans-ASEAN Gas Pipeline (TAGP) in which they will work closely with OPEC on pricing issues.

India – CCI asks shipping conferences to stop cartel activity - Article

Acting Chairman of the Competition Commission of India (CCI), Vinod Kumar Dhall, requested that the shipping pool stop price fixing among its 18 member companies in advance of the introduction of the *Competition Act* amendments. The CCI's position is significant and will have relevance once the CCI is granted enforcement powers following the imminent introduction of competition legislation in Parliament.

Philippines - Privatisation seen netting up to $7B this year - Article

The Philippine government expects between $5 billion and $7 billion from the privatisation of key energy sector assets this year, including plants of National Power Corp., the concession of power grid operator National Transmission Corp. and 40 per cent of PNOC Energy Development Corp (PNOC-EDC). President Arroyo gave strict orders to expedite the energy sector privatisation, as the government focuses on the acceleration of privatisation and reduction of power rates.

UK – BskyB under scrutiny for Amstrad takeover – Original Decision

The Office of Fair Trading announced it will examine BSkyB's proposed takeover of Amstrad given the overlap in industries and that Amstrad already supplies BSkyB with 30 per cent of its set top boxes used for cable television subscribers. BSkyB announced its intention to buy Amstrad last month and the OFT may refer the proposed acquisition to the Competition Commission for a complete investigation.

UK – Competition Commission overturns Ofgem gas rules - Press Release

The Competition Commission has allowed part of an appeal lodged by E.ON UK against the decision by the national regulator Gas and Electricity Markets Authority (GEMA) and Ofgem, to reform the gas offtake distribution regime for the National Transmission System. This appeal is the first of its kind to be successful under the *Energy Act 2004* to modify gas and electricity codes established by GEMA.

UK – Competition Commission still pondering rail case - Original Decision

The Competition Commission released an issues statement relating to its inquiry into the transport rolling stock leasing market and is hopeful of expediting its findings. The inquiry is based upon claims by the Office of Rail Regulation in April 2007 that the franchised passenger services rail market was uncompetitive. In a related development, the OFT may investigate the recent award of a rail leasing contract to National Express Group.

UK – Consumer Council for Water states market uncompetitive - Article

A joint study by water regulators, the Consumer Council for Water (CCW) and Ofwat, has found that eighteen months after liberalising the UK water industry, there remained significant barriers to competition and cited the unwillingness of businesses to switch their water supplier because of uncertainty about the market and an unworkable framework. Ofwat is to launch a more comprehensive inquiry this month.

UK – OFT refers Macquarie/National Grid acquisition to Competition Commission – Original Decision

The Office of Fair Trading (OFT) has referred the completed acquisition of National Grid Wireless Group by Macquarie UK Broadcast Ventures to the Competition Commission for evaluation of its impact on broadcast transmission markets. The OFT announced that Macquarie's proposed remedial action, while substantial, failed to resolve monopoly issues.

US – Federal Court overturns FERC ruling - Original Decision

In a major victory for consumers, the Ninth US Circuit Court of Appeals has rejected Federal Energy Regulatory Commission's (FERC) ruling refusing refunds of A$1.6billion to Californian energy customers following the 2000-2001 energy crisis. The Court introduced crucial testimony it felt was overlooked by the energy regulator, FERC, in which former Enron employees joked about gouging customers during the blackouts.

REGULATORY DECISIONS IN AUSTRALIA & NEW ZEALAND

ACCC/AER

Australian Energy Regulator's Submission on the Retail Policy Working Group Composite Consultation Paper

The Retail Policy Working Group is responsible for developing recommendations to the MCE SCO on energy distribution (non-economic) and retail regulatory functions to be transferred to national energy legislative and regulatory arrangements in the MCE 2007 legislative package. The RPWG engaged Allens Arthur Robinson to prepare a paper for public consultation on options for major components of distribution and retail regulation for consideration by the RPWG and comment by stakeholders and interested parties. On 23 July 2007, the AER made a submission in response to the AAR Composite Consultation paper that broadly supports the proposals for the national framework for non-economic distribution and retail regulation.

Access Dispute between Services Sydney Pty Ltd and Sydney Water Corporation, Arbitration Report, 19 July 2007

On 22 June 2007, the ACCC made its final determination and issued its Statement of reasons for an access dispute under Part IIIA of the TPA between Services Sydney Pty Limited and Sydney Water Corporation.

The dispute concerned the access pricing methodology for three declared sewage transportation services supplied by Sydney Water. In this arbitration, Services Sydney proposed a bottom-up building block methodology whereas Sydney Water proposed a retail-minus methodology. The determination is the first application of access pricing to the water and sewerage industry in Australia. The ACCC identified three key issues in determining the appropriate access pricing methodology – initial asset valuation, structure of access prices and 'postage–stamp' pricing.

Interim determinations in telecommunications arbitrations

The ACCC has published interim determinations, together with the statements of reasons, in two telecommunications arbitrations regarding the supply of the Local Carriage Service and Wholesale Line Rental Service from Telstra Corporation Ltd to Chime Communications Pty Ltd.

MTAS Indicative Price of 9 Cents per Minute Proposed

The Draft Mobile Terminating Access Service (MTAS) Pricing Principles Determination issued by the ACCC for 1 July 2007 to 31 December 2008 proposes an MTAS indicative price of 9 cents per minute.

Petrol Price Inquiry Discussion Paper

The ACCC has released an issues paper on matters relevant to its inquiry into the price of unleaded petrol.

AER draft decision approves increased investment in the Victorian electricity transmission network

The Australian Energy Regulator has issued its draft decision on the transmission determination to apply to SP AusNet's Victorian electricity transmission network for the regulatory control period 1 April 2008 to 31 March 2014.This is the first draft decision released by the AER under the new chapter 6A of the NER, which commenced in November 2006.

AER issues new energy market report

On July 26, 2007, the Australian Energy Regulator issued its first report on the state of Australia's energy market.

AER publishes report on electricity price spikes

The Australian Energy Regulator issued its report into high prices in the National Electricity Market (NEM) in June this year.

AER incentive scheme to reduce electricity transmission congestion

The Australian Energy Regulator has released an issues paper which proposes improved service standard incentives for electricity transmission companies.

AER final decision provides for substantial investment in the Queensland electricity transmission network

The Australian Energy Regulator issued its final decision on the revenue cap to apply to Powerlink Queensland over the regulatory period 1 July 2007 to 30 June 2012. This is the first electricity transmission revenue reset determined by the AER.

Electricity report shows strong transmission investment

On June 28, 2007 the Australian Energy Regulator issued an issues paper which proposes improved service standard incentives for electricity transmission companies.

High Court overturns ACCC decision on access to the Moomba to Sydney Pipeline

The High Court of Australia has upheld an appeal by East Australian Pipeline Limited against a decision of the Full Federal Court, which had affirmed the ACCC's rejection of the access arrangement for the Moomba to Sydney Pipeline.

ACCC issues Telstra accounting separation report for June quarter 2007

The Australian Competition and Consumer Commission issued its 16th imputation testing and non-price terms and conditions report under the enhanced accounting separation regime for Telstra. The report presents data for the quarter ending 30 June 2007.

TO ACCESS AER NEWS RELEASES – **http://www.aer.gov.au/content/index.phtml/tag/AerNewsReleases**

ACCC issues 2005-06 telecommunications market indicator report

On 6 August, 2007 the Australian Competition and Consumer Commission issued its annual report on telecommunications market indicators.

ACCC determination — Sydney water access dispute

The Australian Competition and Consumer Commission issued its Arbitration report on 19 July, 2007 regarding an access dispute between Services Sydney Pty Ltd and Sydney Water Corporation.

The dispute related to the methodology for pricing access to declared sewage transportation services supplied by Sydney Water by means of its North Head, Bondi and Malabar sewerage reticulation networks.

ACCC begins public consultation on Telstra's LCS and WLR exemption applications

The Australian Competition and Consumer Commission issued a discussion paper on Telstra's applications for exemption from the standard access obligations for the local carriage service and wholesale line rental service.

On 9 July 2007, Telstra lodged its exemption application. Telstra sought the exemption in 371 metropolitan exchange service areas, arguing that there is sufficient competitive infrastructure in these areas such that regulation of these services is no longer necessary.

ACCC sets reasonable terms of access to the Line Sharing Service

On 8 August, 2007, the Australian Competition and Consumer Commission published a final determination made in the arbitration of a dispute over access to the Line Sharing Service.

The final determination specifies certain of the terms on which Telstra supplies the LSS to Chime Communications. These are LSS rental charges, and the terms on which wholesale ADSL services are migrated to the LSS. This follows the parties being unable to agree on them, and Chime notifying the dispute for ACCC arbitration.

ACCC issues draft decision on future regulation of the Line Sharing Service

On 21 August, 2007 The Australian Competition and Consumer Commission issued its draft declaration decision for the Line Sharing Service

TO ACCESS ACCC NEWS RELEASES – http://www.accc.gov.au/content/index.phtml/itemId/2332

New Zealand
Commerce Commission

NZ – Commerce Commission rules on wholesale broadband access

The Commerce Commission (NZCC) has handed down a draft ruling on unbundled bit stream access (UBA) in which rivals to Telecom will be able to enter the wholesale broadband internet market at set prices and pass on savings to customers. Telecom argues that the proposed timetable is 'unworkable'.

NZ - Radical changes suggested to telecom obligations

A New Zealand Commerce Commission report has outlined potential changes to the Telecommunications Service Obligation (TSO) paid to Telecom to service rural New Zealand. The TSO mandates free local calling and basic phone and internet services be offered by Telecom nationwide. Telecom's rivals have argued in the past that they should instead be allowed to step in and serve Telecom's loss-making customers using alternative wireless technologies. In an equally significant proposal, Telecom may have to commit to minimum levels of investment in its rural access network to keep receiving the TSO payments, with the report citing evidence of long-term under-investment on Telecom's part.

NZ – Telecom split to go ahead

New Zealand Telecommunications Minister, David Cunliffe has announced he will divide Telecom into three parts composed of network, wholesale and retail businesses to promote competition in the industry particularly in the provision of high speed internet services.

New Zealand Supreme Court affirms Commission's Electricity Threshold Decisions

The Court found that the Commerce Commission acted lawfully in setting both the initial and revised thresholds.

New Telecommunications Commissioner begins five-year term

Dr Ross Patterson begins his five-year term as Telecommunications Commissioner.

New Zealand and Australian Commissions sign agreement

New Zealand's Commerce Commission has signed a cooperation agreement with the Australian Competition and Consumer Commission that will make it easier for the two commissions to coordinate activities.

TO ACCESS NZCOMMERCE COMMISSION NEWS RELEASES –

http://www.comcom.govt.nz/MediaCentre/MediaReleases/200708/MediaList.aspx

National Competition Council

NCC, Application for declaration of the service provided by the Tasmanian railway network

On 2 May 2007, the NCC received an application under Part IIIA of the TPA for declaration of certain rail track and associated infrastructure on parts of the Tasmanian rail network. The Council released its draft determination on 10 July 2007. Its draft recommendation is to declare the service for 10 years.

Moomba to Adelaide Gas Pipeline System: Application to revoke coverage under National Gas Code

Minister's decision and reason for decision released, 16 September 2007

Application for declaration of the service provided by the Tasmanian railway network

Final recommendation forwarded to the designated Minister, 15 August 2007.

Australian Capital Territory

Independent Competition and Regulatory Commission

Commission release Working Conclusions paper

The Commission has released a Working Conclusions report which addresses a number of the technical issues relating to the setting of water prices for the next five years from 1 July 2008. This report is released as part of the current review of water and wastewater prices in the ACT being undertaken by the Commission. Submissions on the Working Conclusions paper should be forwarded to the Commission on or before 19 October 2007.

New South Wales

Independent Pricing and Regulatory Tribunal

Issues Paper - Review of retailer of last resort supply fee for small retail customers

The Minister for Energy has requested that the Tribunal make a recommendation on the setting or calculation of a last resort supply fee that a retailer of last resort may charge a small retail customer transferred to that retailer in a last resort supply event. The Minister has provided a terms of reference and requested that the Tribunal report by 1 October 2007.

Statement of Reasons for Decision - Country Energy Public Lighting Price Increase - 26 June 2007

The Tribunal approves Country Energy's application dated 11 April 2007 to increase public lighting charges.

A Literature Review of underlying costs and industry structures of metropolitan water industries

Set against a background of increased private sector participation in the provision of water and wastewater services, IPART has undertaken a review of the literature on the cost structures of metropolitan water industries, as well as the different ways in which metropolitan water industries are structured, both in Australia and elsewhere.

Review of prices for Sydney Water Corporation's water, sewerage, stormwater and recycled water services from 01 July 2008 - Issues Paper

The Tribunal made a determination of the maximum charges to apply to the provision of general water, sewerage and stormwater services in 2005. This determination applies from 1 October 2005 to 30 June 2009. However, the Premier wrote to the Tribunal on 13 June 2007 requesting a new determination.

Decision - Review of rail infrastructure owner's compliance with the NSW Rail Access Undertaking 2005/06 - Australian Rail track Corporation (ARTC) and Rail Corporation New South Wales (RailCorp) - Ceiling Test

The Tribunal has requested ARTC to submit a draft policy for the Tribunal's consideration, together with its proposal for the allocation of the above 'over' amount to the relevant access seekers.

Review of City Rail fares for 2007/08 - Discussion Paper for 5 September 2007 Public Hearing

IPART has been requested by the Premier to provide the CityRail fare determination by 31 October 2007. IPART has also been provided with terms of reference to undertake an in-depth review of the regulatory framework it uses to determine CityRail fares. Both the letter from the Premier and the terms of reference are attached to this discussion paper.

Issues Paper - review of cost indices for non-metropolitan buses and private ferries - August 2007

The Tribunal has developed a number of preliminary views on alternative inflators for the costs included in the BICI and CVACI, based on the inflators it uses in the taxi industry. This Issues Paper explains these alternative inflators and seeks stakeholder comment on their appropriateness for application to the non-metropolitan bus and private ferry industries.

Report to Minister - Maximum fares for Taxis in NSW - Final Report - July 2007

Every year, the IPART reviews maximum fares for taxi services and recommends changes to these fares to the Minister for Transport.

Northern Territory

Utilities Commission

Possible Review of Certain Regulatory Instruments

The Commission has made an *in-principle* decision to – over the next year or so – revamp the NT electricity ring-fencing code and develop some contestable pricing guidelines, notwithstanding regulatory policy developments that may impact on the NT's electricity market over the same period.

Issues Paper - Possible Review of Certain Regulatory Instruments

Electricity Market Information

The Commission has released its annual report on the composition of the NT Electricity Market.

NT Electricity Market Information 2006-07

Queensland

Queensland Competition Authority

QCA - Final Decision re: Amendment to Electricity Distribution - Determination of Prescribed Services (Aug 2007)

On 26 June 2007, the Queensland Competition Authority released a proposed amendment to its *Electricity Distribution: Determination of Prescribed Services* (September 2000).

QR - Revised Costing Manual (Jul 07)

On 10 May 2007, Queensland Rail (QR) lodged an application with the Authority to amend its 2006 costing manual. On 25 July 2007, the Queensland Competition Authority approved Queensland Rail's proposed amendments to its approved 2006 costing manual.

This revised costing manual will apply from 26 July 2007 until 30 June 2009, and replaces QR's previously approved costing manual.

The Authority’s notification to QR about the approval and a marked up version of the revised costing manual are provided below.

South Australia

Essential Services Commission of South Australia

Review of the Effectiveness of Energy Retail Market Competition in South Australia

In January 2007, the Commission commenced a Review of the Effectiveness of Energy Retail Market Competition for small customers in SA (incorporating both electricity and gas). The Commission has not formed a view at this stage on the conclusions arising from the work of NERA, and believing it appropriate that the Phase 2 and 3 reports be released for public comment before any such conclusions are formed.

2007 Electricity Standing Contract Price Path Inquiry

On 30 April 2007 the Commission commenced an Inquiry into Electricity Standing Contract Prices it should fix to apply from 1 January 2008. The Commission has now released its Draft Report and Draft Price Determination.

2007 Ports Price and Access Review - Final Report

The Commission has undertaken a review of the pricing and access regimes that apply to seven commercial ports in South Australia.

Tasmania

Office of the Tasmanian Energy Regulator

OTTER releases Draft Report and Proposed Maximum Prices for Electricity Distribution Services and Retail Tariffs on Mainland Tasmania

The Draft Report documents the analysis and assumptions made and includes proposals for the determination of maximum prices for distribution services and the provision of meters and meter data services for the four and a half years from 1 January 2008 to 30 June 2012 and for retail tariffs for the two and a half years from 1 January 2008 to 30 June 2010.

Government Prices Oversight Commission

2007 Investigation of Pricing Policies

The Commission has now released its Final Report, which takes account of submissions received in response to the Draft Report. The Minister Assisting the Premier on Local Government has also made a Determination, in accordance with the GPO Act, that specifies the maximum revenues which each of the Authorities may earn for the ensuing three year period.

Victoria

Essential Services Commission

Plan to upgrade CBD Security of Supply

The Essential Services Commission will decide on a proposal by electricity distributor CitiPower to upgrade the security of electricity supply in the Melbourne Central Business District.

Water price review 2008

On 31 July 2007, the Commission commenced a review of the prices to apply to water and sewerage services provided by Victoria's 20 water businesses for the second regulatory period.

Each water business is required to submit a water plan for the five year period commencing 1 July 2008. The Commission expects these water plans will be formally submitted by 8 October after a period of public consultation. Businesses are required to release draft water plans publicly.

The Commission will assess the final water plans against certain principles outlined in the Water Industry Regulatory Order (WIRO) and decide whether to approve or specify the prices, or the manner in which prices are to be determined for the services provided by these businesses over the regulatory period.

Victorian Draft decision proposes cut in gas network charges

The Essential Services Commission has proposed a reduction in gas network charges and an increase in capital investment and service standards for Victorian gas customers in the period 2008 to 2012.

Western Australia

Economic Regulation Authority

Review of the REMCo Gas Retail Market Scheme

The Economic Regulation Authority has released an issues paper, which is available on the Authority's website, on the review of the Retail Energy Market Company (REMCo) gas Retail Market Scheme (RMS).

REMCo is the gas retail market administrator for South Australia and Western Australia.

The company's gas RMS began on 31 May 2004 with the implementation of full retail contestability for gas in Western Australia. The scheme ensures that a retail gas market supplied through a distribution system is regulated and operated in an open and competitive way and is efficient and fair to gas market participants and their customers.

The Authority is responsible for administering Part 2B of the *Energy Coordination Act 1994* which deals with implementing and operating gas retail market schemes. Under the Act, the Authority must review a scheme as soon as practicable after the third anniversary of it starting.

Annual Wholesale Electricity Market Report Discussion Paper

The Economic Regulation Authority is conducting a review of the State's Wholesale Electricity Market (WEM) and has released a discussion paper to help electricity market participants and other interested parties make submissions in relation to the review. The discussion paper incorporating information on how to make a submission is available on the Authority's web site. The review is being conducted under the Wholesale Electricity Market Rules, which require the Authority to report (at least annually) to the Minister for Energy on the effectiveness of the WEM in meeting the Wholesale Market Objectives.

Notice - Railways (Access) Code 2000 - Weighted Average Cost of Capital Determination

The Economic Regulation Authority has determined the Weighted Average Cost of Capital (WACC) for both the urban and freight railway infrastructure as at June 30 under the *Railways (Access) Code 2000.*

NOTES ON INTERESTING DECISIONS

New Zealand Supreme Court affirms Commission's Electricity Threshold Decisions

The Court found that the Commerce Commission acted lawfully in setting both the initial and revised thresholds.

The question for the Court was whether the Commission failed to exercise its power to set thresholds in accordance with the purpose and the requirements of the Act.

In summary, the Court found that:

- The power to set thresholds under section 57G is designed to achieve the broad economic objectives stated in section 57E, and has been given to a body with this expertise. The Act contemplates that the Commission will fashion thresholds that it judges as appropriate to further the section 57E objectives, having considered submissions from interested parties.

- The implied limit on the scope of the power is that thresholds must be relevant to the statutory purpose by contributing to the administration of the targeted control regime. It is not necessary for a threshold to do more than identify potential candidates for control on a general, rather than a specific enterprise basis. Here the breach of the threshold rationally gave rise, in general terms to the need for control.

- It is at the final stage of the process, when examining a particular business, that the Commission is obliged to take into account all aspects of the statutory purpose of promoting efficiency that s 57E covers. Prior to then, thresholds may legitimately be steps on the way which, in isolation, are not necessarily indicative of individual section 57E concerns.

- As the Commission's initial threshold was fixed consistently with the purpose of the subpart, the starting point of the revised price path threshold is legitimate.

- The Commission could have set thresholds which ascertained those companies operating inefficiently and restricted the prices each could charge by imposing controls, including individual profit adjustments. However the time and resources involved in collecting information made this approach unattractive.

- Alternatively, the Commission could set price paths based on the industry information available, fine-tuning them through resetting as it became more informed. In the early stages such thresholds would simply provide a group, whose breaches might show section 57E and who would be investigated. Over time such thresholds would squeeze those behaving as monopolists, forcing them to price efficiently and more cheaply to abandon polices of excessive charging. The Commission chose this approach and it was lawful.

The Court ordered that Unison pay $25,000 costs to the Commission plus reasonable disbursements. Costs in the Court of Appeal and High Court are to be determined by those courts. LINK

Victorian Draft decision proposes cut in gas network charges

The Essential Services Commission has proposed a reduction in gas network charges and an increase in capital investment and service standards for Victorian gas customers in the period 2008 to 2012.

The Commission on 28 August 2007 delivered a draft decision of its review of gas access arrangements, providing for real (after inflation) cuts in gas network charges of between 10.1 per cent and 18.7 per cent in 2008, depending on the gas distributor. Victoria is serviced by three monopoly gas distribution networks, through which energy retailers sell natural gas to more than 1.6 million customers. Under the draft decision, gas network charges for customers in the Multinet distribution area (inner and outer eastern suburbs) will be reduced by 18.7 per cent in real (after inflation) terms.

Network charges for customers in the Envestra distribution areas in northern and eastern Victoria and in Albury will be reduced in 2008 by 10.1 per cent and 15 per cent in real terms respectively, while network charges for customers in the SP AusNet distribution area (western and north-western suburbs and west of the state) will be reduced by 11.5 per cent in real terms.

Gas network charges account for around 40 per cent of the typical household gas bill. Distributors submitted their proposed access arrangements for the 2008-2012 period, as required under the National Gas Code, to the Commission in March this year. It has also proposed further real price cuts of between one and three per cent per annum for each year of the 2009-2012 period.

ESC Chairperson Greg Wilson said the proposed price cuts in distribution, if confirmed by a final decision of the Commission, would result in energy retailers paying less for the distribution of gas supply.

'If these price cuts are confirmed, we would expect that the retailers pass through the savings to gas customers,' he said.

In addition to the price cuts, the Commission has approved total capital expenditure over the 2008 to 2012 period of $773 million (in 2006 dollars). This is equivalent to a 24 per cent ($142 million) increase on the actual capital expenditure from 2003 to 2006 and anticipated expenditure in 2007.

The Commission's draft decision also provides for a 5.6 per cent weighted average cost of capital (WACC), which is less than the 6.8 per cent WACC provided for the five-year period ending 31 December 2007. This reflects prevailing market conditions, including an assessment of equity beta of 0.7 (previously 1.0).

Victorian Supreme Court Rules on Gas Licence Requirement

The Supreme Court of Victoria has ruled that Alinta Asset Management (AAM), the provider of the vast majority of the functions of gas distributor Multinet, is required to hold a gas distribution licence under the *Gas Industry Act*, and is therefore a service provider under the National Gas Code.

AAM initiated action in the Supreme Court to test whether it would be required to hold a licence for operating the gas distribution network on behalf of Multinet and if it were a service provider under the Code.

In her decision, Justice Elizabeth Hollingworth found that AAM fell within the definition of 'service provider' under the Code and was therefore required to comply with the access arrangements provisions in respect of the Multinet system.

Justice Hollingworth also found in favour of the Commission on the licensing matter. In her decision, Justice Hollingworth stated that: 'Multinet has effectively handed over all of the functions which are required to be performed to operate and manage the Multinet system. It is the aggregation of all the contractual responsibility under the Operating Services Agreement that leads to the conclusion that AAM is, and has, at all material times since 23 July 2003, been the operator of the Multinet system.'

Pricing Policies of the Tasmanian Bulk Water Authorities

The Government Prices Oversight Commission of Tasmania recently released its Final Report on the fourth three-yearly review of the pricing policies of the three bulk water authorities. The Commission's process involved release of the terms of reference, a round of submissions on the terms of reference, a draft report, another round of submissions and a final report. The report covers *inter alia*, costs, efficiency and quality of supply of the monopoly service; protection of consumers from the adverse effects of monopoly power; and the reasonable rate of return for monopoly providers. The 137-page final report contains some interesting empirical and theoretical analysis.

The Commission favours a two-part pricing structure with a fixed charge and a volumetric charge. It recognises that both components could lead to cross-subsidies. The volumetric charge is based on long-run marginal cost inclusive of a marginal capacity cost, and, according to the Commission, the volumetric charge is desirably determined on a nodal basis. However, the Commission does not oppose some averaging of prices, but weighs the efficiency cost of this against the complexity. None of the three bulk water authorities applies nodal pricing in its volumetric charge. However, while Esk's volumetric pricing was found to be a 'reasonable approximation' of nodal pricing and Cradle Coast's was 'acceptable', the Commission did draw attention to cross-subsidies inherent in Hobart Water's pricing.

Another important feature of the report is the detailed empirical analysis of the costs and partial productivity indicators of the three authorities.

Australian Energy Regulator (AER) Draft Decision on SP AusNet's Electricity Transmission Determination

The Australian Energy Regulator (AER) released its draft decision on SP AusNet's electricity transmission determination on 31 August 2007. The determination will be for the period 1 April 2008 to 21 March 2014.

Among other issues addressed, this review dealt with SPAusnet's assertion that the nominal risk-free rate is no longer best approximated by the yield on Commonwealth Government Securities (CGS). It was alleged that an undersupply of CGS and increased institutional demand has suppressed the yields on these securities, creating a downward bias in nominal CGS yields. Given the ACCC uses such yields to determine a forecast of inflation, it was asserted that once accounted for, the resulting inflation forecast should be reduced. The AER's Post Tax Revenue Model uses inflation forecasts to obtain the current value of future capital expenditures. In addition, the yields on nominal CGS are used to calculate the nominal risk free rate, which partly determines the required rate of return (or Weighted Average Cost of Capital).

SPAusnet's submission canvassed alternative approaches to correct for the perceived bias in the nominal risk free rate. However, the AER found that the National Electricity Rules preclude it from accepting the use of other methodologies to calculate the nominal risk free rate for the purposes of determining the required rate of return. With regard to the use of these yields to forecast inflation, the AER sought comments from the Reserve Bank of Australia (RBA) and Australian Treasury. This consultation led the AER to conclude that the methodology to forecast inflation involving the yields on nominal CGS might not produce the best estimate of inflation at present. The AER's draft determination concludes that a more general approach to inflation forecasting is preferred, resulting in an estimate close to 3 per cent.

Upgrade to the Security of the Electricity Supply in the Melbourne CBD

Under the proposed N – 1 Secure standard, after one network had already failed, CitiPower would be able to reconfigure the network to ensure supply is maintained in the event of a second network outage, within 30 minutes of the first network element failing. Analysis conducted for CitiPower claimed that loss of electricity supply in the CBD would impact in many ways, including traffic chaos, loss of supply to hospitals and loss of economic and consumer activity.

CitiPower has proposed that the costs of the CBD supply upgrade would be met by all customers of the CitiPower distribution base, not just those of the CBD. In its proposal, CitiPower stated that it would be administratively difficult to allocate the costs of the security enhancements, and that it would be reasonable to spread the costs over the entire distribution network customer base.

CitiPower contended that all CitiPower residential customers would face an increase in their network charge of 1.8 per cent per annum. Network charges account for about 40 per cent of the total electricity bill. CitiPower has applied to the Commission for approval to recover the financing costs associated with $42.9 million ($2006) in capital expenditure for the project. A further $9.5 million ($2006) in capital expenditure is proposed to be undertaken in the next regulatory period starting in 2011.

CitiPower plans to upgrade the security of electricity supply from the present 'N – 1' standard to the 'N – 1 Secure' standard. The N – 1 configuration of the CBD network means that only one network element in the CBD can fail without loss of supply to CBD customers.