# Information gathering for ring fencing and other regulatory purposes

## Utility Regulators Forum discussion paper

Prepared for the Utility Regulators Forum by:
Chris Pattas
Australian Competition and Consumer Commission
Level 35, The Tower, Melbourne Central
360 Elizabeth Street
Melbourne Vic 3000

Phone: (03) 9290 1858
E-mail: chris.pattas@accc.gov.au

Stephen Goldwater
Australian Competition and Consumer Commission
Level 35, The Tower, Melbourne Central
360 Elizabeth Street
Melbourne Vic 3000

Phone: (03) 9290 1842
E-mail: stephen.goldwater@accc.gov.au

**October 1999**

ISBN 0 642 40231 0



**Disclaimer**

The Utility Regulators Forum was established in recognition of the need for cooperation in a federal system among State-based regulators. The forum consists of regulators operating in industries where utilities that traditionally operated as monopolies are being opened up to competition as a result of the competition reform process. By acting as a focal point for regulators in different jurisdictions the forum will:

? foster understanding of issues and concepts faced by regulators on similar industries;

? minimise overlap of regulations for large users who operate across jurisdictions;

? provide a means of exchanging information; and

? enhance the prospects for consistency in the application of regulatory functions.

The following paper does not necessarily represent the views of the members of the Forum, but is released by the Regulators Forum to encourage discussion in a range of important regulatory issues.

# Contents



## Appendixes

# Summary

This paper deals with a number of issues concerned with information gathering for ring fencing and other regulatory purposes by regulators in the utility sector in Australia, in particular:

? an overview of the approach and rationale of ring fencing separation provisions for vertically integrated entities in the utility sector;

? minimum accounting and non-accounting information required to regulate a vertically integrated entity; and

? a description of current information gathering powers and information collected by the Independent Pricing and Regulatory Tribunal and Office of the Regulator General Victoria.

The main focus is on the information requirements that utility regulators need to carry out their responsibilities and the systems, such as ring fencing, which can be utilised. These responsibilities relate to financial/performance monitoring, the setting or oversight of retail prices, the administration of access requirements and competition responsibilities. Ring fencing, which attempts to separate activities on the basis of facilitating competition outcomes, is seen as an integral information system for the regulation of vertically integrated incumbents and is discussed first.

In the context of competition policy, ring fencing involves the identification and isolation of activities, assets, costs, revenues and community service obligations of goods or services derived from a monopoly element, or one not subject to strong competitive pressures, that are provided by an integrated entity. The process also involves the identification and isolation of potential incentives or practices of a non-accounting nature which may result in anti-competitive behaviour. Ring fencing also includes the selection of appropriate processes to be implemented by the regulator to eliminate the potential for an integrated entity to engage in anti-competitive activity.

Vertical and horizontal integration which encompass a natural monopoly element, present opportunities for cross-subsidisation. Monopoly returns made in the monopoly market may be used to finance otherwise unprofitable prices in a competitive market, potentially driving out or disadvantaging competitors. Indeed, even the prospect of such conduct may deter competitive market entry unless appropriate safeguards are in place**.**

The rationale of ring fencing is to assist the introduction of effective competition into markets traditionally supplied by public monopolies. Where an incumbent firm has developed into an integrated monopoly during its period of protection from competition, structural reforms, such as imposing a ring fencing regime, may be required to assist with controlling excessive market power and reduce the propensity for these firms to engage in anti-competitive behaviour. These processes are likely to decrease the potential for anti-competitive behaviour by the regulated entity and to increase the contestability of the market with benefits flowing to end-users.

The paper acknowledges that ring fencing structural obligations required by the regulator of the regulated entity should be flexible and dependent upon particular circumstances in the industry and include a cost/benefit analysis of alternative arrangements with an assessment of the extent to which competition will be enhanced.

In response to a draft of this paper a number of submissions were received advocating structural separation as the only appropriate method for regulation of monopoly elements of vertically integrated firms. It is acknowledged that policy makers will need to undertake cost benefit analysis to assess the appropriate method of regulation.

An assessment of the costs and benefits of different separation or integration models needs to be undertaken by the relevant government to assess the impact on the public benefit of the preferred method of separation. However, it is not the purpose of this paper to consider the relative merits of structural versus nominal separation. It is more concerned with how to implement effective ring fencing or separation requirements in circumstances where the decision has been made by policy makers for the regulated and competitive businesses to maintain some formal relationship with each other.[1]

1 Note that in relation to informal relationships as between fully separated and independently owned entities, concerns in relation to any anti-competitive contractual arrangements between them can be dealt with under Part IV of the Trade Practices Act. See also the section on Minimum non-accounting separation requirements.

# Minimum ring fencing separation requirements

## Introduction

Before looking at the minimum requirements for ring fencing, a brief overview of the various kinds of ring fencing approaches are identified.

The ring fencing structural obligations required by the regulator of the regulated entity should be flexible and dependent upon circumstances in the industry.

The various approaches are:

? accounting/financial separation;

? accounting/financial separation coupled with non-financial ring fencing provisions;

? legal separation with non-financial ring fencing provisions; and

? full structural separation with separate ownership.

In choosing which approach is appropriate the regulator should take into consideration the following circumstances;

? the administrative costs of regulation;

? the costs to the regulated entity in limiting or eliminating its ability to achieve economies of scale and/or scope;

? the level of competition;

? the level of barriers to entry;

? the availability of substitute products and services;

? the size of the market;

? the economic importance of the goods and services provided; and

? the extent to which competition would be enhanced by the ring fencing option.

An assessment of these circumstances will assist the regulator to determine the extent of information required and whether structural separation should be the preferred position for ring fencing.

## Definition of ring fencing

In the context of competition policy, ring fencing can be defined as identifying and isolating the activities, assets, costs, revenues and community service obligations of goods or services that are derived from a monopoly element, or one not subject to strong competitive pressures, that are provided by an integrated entity.

The degree of separation required is not restricted merely to 'accounting' or financial separation which is designed to make the financial relationships between two parts of a business more transparent. It is also necessary to identify and isolate potential incentives or practices of a non-accounting nature which may result in anti-competitive behaviour. Ring fencing also includes the selection of appropriate processes to be implemented by the regulator to eliminate the potential for an integrated entity to engage in anti-competitive activity.

Ring fencing includes the separation of financial accounts, the consolidation of financial accounts across different products and services within the company and its subsidiaries, the physical and procedural internal divisions (known as Chinese walls) to contain certain information and activities, the protocols for the disclosure and exchange of information between internal entities, and the consistent application of rules for cost/revenue attribution and for an appropriate allocation of common or joint costs, including overhead costs. Penalty provisions may be required to discourage incentives for the integrated firm to engage in anti-competitive behaviour.

Ring fencing should involve separation both at the vertical and horizontal level where the entity is fully integrated across upstream and downstream activities.

### *Vertical separation*

By establishing a de facto structural separation of bottleneck upstream service activity from downstream competitive retail service activity within the vertically integrated enterprise, the regulator has, in principle, more information to identify (and therefore inhibit) anti-competitive behaviour, such as price discrimination (on other than efficiency grounds) between internal and external sales of upstream services.

### *Horizontal separation*

Structural separation should also be obtained at the horizontal level where different intensities of competition, such as at the retail level, may give rise to anti-competitive behaviour. Horizontal separation can also help to improve the effectiveness of the overall separation process.

There are two situations in which horizontal separation is appropriate;

? first, where a single entity is operating in two markets, one which is competitive, and the other not (for example, a retailer operating in franchise and contestable markets); and

? second, where the creation of a competitive market would be fundamentally undermined by an incumbent's dominance (for example, electricity generation) and horizontal separation is required to prohibit collusion between the new competitive entities.

***Auditing***

Ring fencing should also involve auditing by the regulator to ensure that the ring fencing principles are applied and that satisfactory outcomes are achieved. In addition, it is desirable that the separation principles adopted are subject to a one-off independent audit.

## The competition rationale for ring fencing

The rationale of ring fencing is to assist the introduction of effective competition into markets traditionally supplied by public monopolies. Where the incumbent firm has developed into an integrated monopoly during its period of protection from competition, structural reforms may be required to dismantle excessive market power and increase the contestability of the market.

A number of industries currently dominated by public monopolies involve an element with natural monopoly characteristics, in the sense that a single firm can supply the entire market most economically — examples include electricity transmission grids and rail tracks. In many cases, these natural monopoly elements have been integrated with potentially competitive activities — such as electricity generation or rail services. Integration of this kind may be through a vertical relationship — so that one activity is upstream or downstream from another — or a horizontal relationship — where there are no essential links between the two activities.

Vertical and horizontal integration which encompass a natural monopoly element, present opportunities for cross-subsidisation. Monopoly returns made in the monopoly market may be used to finance otherwise unprofitable prices in a competitive market, potentially driving out or disadvantaging competitors. Indeed, even the prospect of such conduct may deter competitive market entry unless appropriate safeguards are in place.

A second concern can arise where there is a vertical relationship between the two activities, particularly when access to the natural monopoly element is essential for effective competition in the downstream or upstream market. For example, effective competition in electricity generation requires access to electricity transmission grids. In this case, integration of the natural monopoly element (transmission grids) and a potentially competitive activity (electricity generation) raises concerns that control over access to the monopoly element may be misused to stifle or prevent competition in the potentially competitive sector. Even if access is not actually misused, the potential for such behaviour may deter new entry to, or limit vigorous competition in, markets dependent on access to the natural monopoly element.

Problems can also arise from 'cultural' protocols, such as common logos, shared marketing staff and use of common facilities like centralised computing.

To address these concerns there is a need to ring fence the natural monopoly element to promote competition in other activities, enable competitive access to the natural monopoly element and to ensure that anti-competitive cross-subsidisation does not occur.

## Regulatory functions applicable to ring fencing

The regulatory authorities can use the information derived from a ring fencing regime to:

? develop, regulate or audit access prices to the natural monopoly;

? assess the level of competition in the provision of natural monopoly goods or services, including the regulation of final prices;

? assess the level of efficiency at which natural monopoly goods or services are provided;

? benchmark against other natural monopolies, both domestic and international; and

? identify anti-competitive behaviour such as cross-subsidisation or discrimination.

## Minimum accounting separation requirements

The process of accounting ring fencing is to separate the natural monopoly elements from potentially competitive activities. A summary of the requirements to enable accounting separation is detailed below. Further, proposed minimum information requirements are detailed in Appendix C.

### Cost attribution

Cost attribution is a generic task involving the general process of assigning costs and revenues to an entity or activity undertaken by an entity. Direct entity or activity costs are quite easily assigned. However, joint or common costs (or revenues) require an allocation methodology (see the section on Cost allocation below).

Comprehensive details of the methodology of cost and revenue attribution to the entity which includes the natural monopoly element should be provided for the following:

? activities performed;

? revenues;

? assets;

? depreciation;

? direct operating costs;

? indirect operating costs; and

? liabilities.

Further, details of the costs and revenues associated with community service obligations should also be identified.

Costs attributable to the natural monopoly element should be provided on both an economic basis and on an historical cost basis. Also, the consolidation of financial accounts across different products and services within the company and its subsidiaries (where appropriate) should be provided.

The basis for cost attribution can be undertaken in a number of ways. The following are the two most common ways of attributing costs and revenues:

### *Transfer pricing*

Costs are attributed by the development of internal transfer pricing within the organisation. The basis of transfer prices would need to be comprehensively documented.

An accounting separation should be able to elicit internal transfer prices relating to the natural monopoly element(s) within the vertically integrated firm. The costs (including profit) attributable to natural monopoly products and services are, in effect, the implicit transfer prices paid by internal firm users for these products and services. It is important to be able to identify these 'prices' for the purpose of making comparisons with access prices charged to external users to ensure there is no anti-competitive price discrimination. Alternatively, it is possible that a vertically integrated firm can use an explicit transfer price approach to allocate common costs.

### *Cost accounting attribution*

This method involves costs based on both a real rate of return (forward-looking costs) and an historical cost basis. Total costs (real and historical) and revenues attributable to the total entity that includes the natural monopoly element need to be identified prior to the cost/revenue allocation between the natural monopoly element and non-natural monopoly elements.

## Cost allocation

Details of the methodology of cost and revenue allocation for common (or joint) costs to the natural monopoly should be provided for the following costs categories:

? assets;

? depreciation;

? direct operating costs; and

? indirect operating costs.

Cost drivers need to be identified to allocate costs between activities, products and services.

The two main ways of allocating common costs are:

***Transfer pricing***

Costs are allocated by the development of internal transfer pricing within the organisation.  The basis of transfer prices would need to be comprehensively documented.

***Cost accounting allocation***

This method involves the identification of cost drivers and allocating costs on the basis of how costs are actually incurred.

### Efficiency indicators

To ensure that access prices charged by the natural monopoly are not excessive the firm will need to provide evidence that the products and services provided under an access regime are delivered on an efficient basis.

Analysis of efficiency indicators will enable the regulator to assess whether products and services are being provided on an efficient basis.  The results may enable the regulator to reduce access prices because of inefficiencies such as over-investment in assets or unnecessarily high operating or overhead costs.

## Minimum non-accounting separation requirements

### Ring fencing from related businesses

Details of policies and implementation methods to ensure that the natural monopoly does not:

? pass on information to its other businesses which is not generally available to other competitors to those business activities;

? cross-subsidise its other business activities; nor

? discriminate between customers in an anti-competitive manner, such as anti-competitive discriminatory pricing or preferential scheduling to its other businesses.

### Ring fencing of investment and operational cost decisions

Details of policies and implementation methods of tendering for the entire entity for investments or operational cost centres.  This will assist in ensuring that activities are subject to competitive market forces and to avoid preferential treatment to subsidiaries, related entities or preferred customers.

### Ring fencing of natural monopoly from its parent company

If the natural monopoly is owned by a larger corporation or consortium, ring fencing measures will be required to ensure that there is no unfair shifting of profits toward the ultimate owner.  Information will be required for:

- management fees to the parent company;
- reimbursement of parent company expenses;
- internal loans at interest rates which are not at market rates;
- transfer pricing which is not market tested; and
- licence fees for know how and intellectual property.

Consideration also needs to be given as to whether full separation, with the establishment of a separate legal entity, should be required for enterprises providing natural monopoly goods and services. Adopting a policy of full separation may impose additional regulatory costs and reduce a firm's ability to achieve some economies of scale and scope. However, full separation does provide a greater degree of veracity of the ring fencing process and increases its effectiveness in detecting anti-competitive behaviour and as a monitoring device to assist the regulator in performing its functions. Full separation also overcomes the problems associated with the more difficult processes of ring fencing, such as 'cultural' problems that exist with a merged entity — e.g. the use of common logos and centralised computing facilities.

Full separation does not of course necessarily guarantee that the regulated entity will not attempt to undertake conduct that would unfairly advantage itself. It has been suggested that newly separated firms, even when independently owned, may use contractual and other arrangements to engage in anti-competitive conduct. It should be noted, however, that such contracts and arrangements are likely to be in breach of Part IV of the Trade Practices Act, particularly ss 45, 46 and 47, and as such could attract significant financial and other penalties.

Such conduct is therefore better addressed through these Part IV provisions and it is not clear that specific ring fencing arrangements are required to deal with relations between independently owned entities.

## Ring fencing process options

There are a number of ways in which the ring fencing process can be implemented. Ring fencing regulation can be imposed in a comprehensive manner requiring a high level of intervention by the regulator in prescribing the processes and methods involved. Alternatively, a more light handed regulatory method could be applied which gives the firm discretion as to how it will comply with the requirements. Below are two possible approaches which could be adopted.

### Provision of undertaking

This involves the firm making a ring fencing undertaking to the regulatory authority which outlines what administrative arrangements have been established by the firm to ensure effective implementation of a comprehensive ring fencing regime. The undertaking would include nomination of the persons who have responsibility to see that the undertaking is delivering satisfactory outcomes and will contribute to the transparency and accountability of matters contained in the undertaking.

The responsibility of the nominated persons would include:

? monitoring, reporting on and enforcing compliance with matters set out in the undertaking;

? commissioning independent compliance audits;

? addressing issues relating to security of information and operational standards and protocols; and

? refining dispute resolution procedures.

The ring fencing undertaking would need to be:

? documented to allow timely external auditing;

? written, structured and presented in a manner which is easily understood by general audiences;

? consistent over time and not changed without the prior approval of the regulator;

? designed to allow the publication of regular information on the costs of providing ‘unbundled’ natural monopoly services;

? able to identify and seek the regulators’ approval for any cross subsidies or preferential treatment given to the host firm, affiliate or customer; and

? able to identify any discounts offered to the host firm, affiliate or customer and justify why the discounts should not be made immediately available to non-affiliates/customers (It should be noted that in NSW, discounts require approval by the regulator).

The regulated natural monopoly will have to report regularly on:

? the extent to which the firm is complying with the undertaking; and

? highlighting any non compliance and if so what action is being taken by the firm to ensure compliance including a time frame for achieving compliance.

The regulator may see it desirable to appoint an external agency to monitor compliance by the regulated entity.

### Mandatory regular reporting of accounts/protocols

Alternatively the regulator could impose a mandatory requirement on the firm to regularly provide comprehensive reports to ensure compliance with the ring fencing requirements. These reports would be subject to frequent and regular audit by the regulator.

Such a prescribed process would be similar to the approach adopted in the Gas Code.

# Information gathering and reporting

## Introduction

Regulators in carrying out their responsibilities, be they price setting, compliance and/or or arbitration, require good information.[2] The challenge for a regulator is to target and extract relevant information from all available sources recognising that regulators will never have the same level of information as the regulated entity.

Regulators need to understand how to use information. Information is not costless — there will always be trade-offs between the cost of obtaining information (including the cost to the provider and the regulator) and the value of that information.

## Information

Good information is determined often:

? by what is necessary in order for a regulator to be able to produce cogent and credible reasons for their decisions; and

? by what is necessary for stakeholders, particular customers to be satisfied that prices are appropriate.

The importance of providing stakeholders with sufficient information to enable them to satisfy themselves that prices are appropriate should be highlighted as a valuable regulatory tool. Disclosure of information is an important element in the regulatory process. The major problem facing a regulator is that of information asymmetry. Provision of information to the regulator helps reduce this. Public provision of information can reduce the problems of information asymmetry considerably. Other participants have a strong interest in the outcomes and may often have considerable expertise. Given access to information, their inputs can be of considerable value to the regulator. Both IPART's and ORG's experience in establishing gas access regimes are an example of this.

## Information gathering

Regulators are generally provided with legislative powers to gather information. Appendix 1 provides a brief explanation of information gathering powers under the national electricity and gas codes. As an example of general powers provided to regulators through legislation, IPART's information gathering powers are also provided in Appendix A.

2 In this context good information refers to information that is adequate and appropriate for the decision being made.

Often legislation provides regulators with powers to gather information only while they are carrying out an inquiry or investigation. However, it is essential that information be gathered on an ongoing basis rather than an inquiry basis, to monitor both performance and compliance.  Furthermore, information gathering powers should not be limited to information about the regulated entity as it is often important to investigate arrangements, for example between the electricity industry participants and their related businesses to curtail cross-subsidisation.  Thus, it is necessary to be able to obtain information about the business as a whole.

## Approaches adopted by overseas regulators to information gathering

Typically overseas regulators collect large volumes of detailed information.

### North American

The North American regulators combine rate of return regulation with a due diligence/pubic disclosure of information regime.[3]  This requires detailed information to be gathered by regulators and then made publicly available. This requires a huge amount of very detailed information to be collected from each utility.

North American regulatory agencies have found it necessary to be very prescriptive with their information requests to allow both themselves and other participants to make good use of the information submitted by utilities. For example both the Federal Energy Regulatory Commission (FERC) and the Canadian National Energy Board (NEB) have very detailed ‘filing requirements’ for their regulated utilities.  Utilities are required to file profit and loss accounts and balance sheets accompanied by very detailed breakdowns of revenues, expenses, assets and liabilities.

The filing requirements provide mandatory guidelines as to which accounts all revenue, expenses, assets and liabilities are to be allocated.  For example, the FERC Code for Gas Utilities provides:

887 Maintenance of mains

This account shall include the cost of labor, materials used and expenses incurred in the maintenance of distribution mains, the book cost of which is includible in account 376.

Items:

1. supervising.
2. trenching, backfilling, and breaking and restoring pavement in connection with the installation of leak or reinforcing clamps.
3. work performed as the result of municipal improvements, such as street widening, sewers, etc., where the gas mains are not retired.
4. municipal inspections relating to maintenance work.
5. other work of the following character:
    a. locating leaks incident to maintenance
    b. cutting off mains without replacement
    c. repairing leaking joints
    d. repairing broken mains
    e. repairing leaks on main drip riser or value test pipe
    f. bringing main value box, main drip riser box, value test pipe box, or pressure pipe roadway box up to grade

3 The North American regulatory style is rate of return regulation, i.e. given regulatory supervision of an approved asset base and costs, a set of prices that complies with the regulated returns is approved.

g. cleaning, repainting, coating, and wrapping exposed mains

h. repacking main valves

i. locating and clearing gas main faults

j. lowering and changing location of mains

k. trenching, backfilling, cutting-in or removal of pipe not retired in connection with the installation of leak clamps, values, or drips

l. watching and lamping open cuts associated with maintenance

m. restoration of permanent pavement in connection with work chargeable to maintenance

n. emergency stand-by time associated with maintenance

o. repairing sewers, drains, walls etc., when damaged by maintenance work

p. making electrolysis tests to maintain life of plant

q. repairing property of others damaged by maintenance work

Regulatory staff and or other participants must review this large volume of detailed information. Good regulatory practic e requires that only information relevant and useful to the regulator and or other participants be collected. Each utility's FERC accounts are publicly disclosed. While regulators may not directly use all the information, others such as customers make use of the data.

The disadvantages of this approach to information gathering and public disclosure include:

? more information may be collected than is required to make regulatory judgments;

? it may be resource and time intensive for the regulator and other participants;

? utilities may use their information asymmetry advantage to engage the regulator in lengthy debate on unimportant detail.

Advantages of this approach are:

? public disclosure of detailed information allows participants such as customers to make informed contributions to the regulatory process;

? comparability which should facilitate benchmarking.

**United Kingdom**

In the UK regulators such as The Office of the Electricity Regulator (OFFER) and the Office of the Water Regulator (OFWAT) adopt incentive regulation.[4] Typically large volumes of information are collected from utilities by these regulators. For example OWFAT has established a rigorous information gathering procedure. Information collected annually from the water companies consists of the July Return and Regulatory Accounts (outputs, measures and financial analyses relating to the year to the previous March), the Principal Statement (proposed price increases and tariff related details) and other information on customer services (for example, disconnection statistics submitted in April and September).

4 Incentive regulation is the use of rewards and penalties to induce the utility to achieve desired goals where the utility is afforded some discretion in achieving goals.

Non-financial data collected comprises basic statistics on: the scale of company services (for example number of people/properties served or affected, volumes of water delivered and sewage collected); progress with particular activities (for example metres installed and lengths of water mains/sewers refurbished and replaced); and explanatory factors used, for example, in assessments of operating cost efficiency.

The Principal Statement provides information annually on tariff details to ensure first that increases in average charges remain within the price limits and second that charges avoid both undue discrimination and undue preference.

Information is also collected on quality of supply and the number and type of customer complaints, disconnection and bad debt policy, and number of disconnections.

OFWAT issues detailed guidelines on how assets, liabilities, revenues and expenses should be recorded for the purposes of the regulatory accounts.

The Director-General of OFWAT, for the purposes of the 1999 Periodic Review, has adopted a 'general presumption of non-confidentiality for all information submissions. The burden of proof will be on those requiring a confidentiality restriction to justify this. The justification will need to address the appropriate 'substantial harm' test outlined in the Government's Freedom of Information White Paper'.[5]

### New Zealand

New Zealand's approach to regulation of its electricity and gas utilities is termed light-handed. The Ministry of Commerce describes light-handed regulation as:

- use of the existing competition policy regime, i.e. the Commerce Act 1986, to deal with anti-competitive behaviour, including the possibility of court action by private parties or the Commerce Commission;
- extensive information disclosure, to make transparent the performance of electricity and gas businesses with market power; this will facilitate both negotiation with these businesses and recourse to the provisions of the Commerce Act; and
- the threat of further regulation, such as introduction of price control, if market dominance is abused.

In the electricity industry the Electricity (Information Disclosure) Regulations 1994 sets the information regime. This regulation is currently under review with the aim of incorporating more stringent disclosure requirements. The regulation prescribes that all electricity utilities should publicly disclose (within certain periods) financial statements, financial performance measures, efficiency measures and that asset

5 OFWAT, The framework and business planning process for the 1999 Periodic Review, February 1998, p. 60.

valuations comply with the optimised deprival value (ODV) method as set out in the ODV handbook. Schedules to the regulations define the performance measures. The Regulation also requires separate certification by auditors for the financial statements, performance measures and the ODV valuation. This approach is relatively information-intensive.

## What information should be gathered?

Australian regulators' experiences in carrying out their regulatory functions in:

? establishing medium term price paths in the water industry;

? establishing medium term revenue paths for electricity transmission and distribution; and

? establishing medium term access regime to gas networks

indicates that there is a minimum level of financial and non-financial data that must be considered in order for an informed regulatory judgement to be made. The type and level of detail will in part be influenced by any legislative requirements and national or State code requirements.

Experience has demonstrated that, in making judgments on sustainable revenues, information is required by both the regulator and other participants on:

? efficient costs;

? return of capital; and

? return on capital

In considering efficient costs regulators require information:

? on current and forecast costs levels;

? to undertake a benchmarking study;

? to explain how costs are allocated between the regulated and non-regulated businesses of a utility;

? to ensure that common or joint costs are not over-recovered, i.e. costs allocated to each business unit, including non regulated units, are not recovered more than once;

? to ensure that while meeting productivity targets and the current revenue caps quality of supply is maintained to satisfactory levels;

? non-financial data on what service standards the utility must meet;

? to satisfy any legislative requirements (e.g. IPART Act or ORG Act ) and national or State code requirements;

? to model impacts of efficient cost analysis on profitability, viability and cash flows;

In considering return on and of capital issues regulators require information covering:

- capital expenditure — past levels and forecasts split between renewals and growth, and the explanations on the major drivers of capital expenditure;
- funding program for capital expenditures;
- relationship between capital expenditure and quality of supply;
- description of asset valuation methodology plus sufficient information for the regulator to estimate an appropriate range of asset values — both gross and net values;
- weighted average cost of capital plus supporting information;
- to satisfy any legislative requirements (e.g. s. 15 IPART Act) and national or State code requirements;
- non-financial data on service standard requirements;
- to model impacts of capital costs analysis on profitability, viability and cash flows;

In considering pricing issues and impacts, information is required covering:

- description of cost of supply methodology;
- customer profiles, including contribution of each customer class to system peak and total load;
- impact analysis.

Appendix C provides the details of the proposed minimum information to be collected from utilities when a regulator is undertaking a medium term review.

In summary the proposed minimum information requirements to be collected include:

- five year financial forecasts;
- capital costs analysis;
- non-capital costs analysis; and
- non-financial performance analysis including quality of supply.

The proposed schedule of information should form the basis of ‘good’ information for a regulator to make regulatory judgments. More detailed information may in fact result in collection of data which may not be used by participants, secretariats in their analysis or regulators in their decisions.

There will be benefits if Australian regulators can gather like information. Benchmarking of both financial and non-financial information will be enhanced if regulators can collect like data and can also **share** the collected data.[6]

Collecting the same data from utilities does not ensure that useful benchmarking can be undertaken. The nature of accounting is such that utilities can treat like revenues and expenses quite differently yet still comply with generally accepted accounting principles and accounting standards.

Issues such as definition of costs and allocation of joints or common costs require consistent treatment to facilitate useful benchmarking. The level of prescription required is ultimately a judgement. IPART's experience with the electricity regulatory accounts tends to indicate that some level of prescription will be necessary.[7]

A characteristic of 'good' information is that it is reliable. Reliability requires some form of independent testing or verification. In the UK, OFWAT has developed the Reporter model. OFWAT has approved organisations to act as reporters. Reporters are currently appointed by the utilities but OWFAT plans in the near future to make these appointments. Reporters provide certification on both financial and non-financial information.

As an indication of the type of information currently collected by Australian regulators, a brief outline of both IPART's and ORG's information requirements for the electricity industry is provided in Appendix B.

6 The collection of like data by regulators will obviously assist benchmarking. For benchmarking to be successful regulators require a good understanding of a utility's business.

7 Before regulators can be prescriptive, a good understanding of the regulated business is required.

# Appendix A. Information gathering powers

## A.1 IPART Act

Section 22 of the IPART Act gives IPART power to gather any specified information from an officer of an agency or any other person. Penalties for not complying with requests for information or for making false and misleading statements to IPART are a maximum of six months imprisonment and/or a $10 000 fine. However, these information-gathering powers apply only when IPART is conducting an investigation under its Act.

IPART also requires information-gathering powers between investigations for the purposes of monitoring performance and compliance with determinations. IPART has made representations to Government to strengthen the IPART Act information-gathering powers.

### Confidential information

Associated with information-gathering powers is the power to release information to the public. Under the IPART Act, all documents must be released if requested by the public unless they fall into a category of ‘exempt documents’ under the FOI Act (documents disclosing trade secrets, business affairs, etc.). Even then IPART has a residual discretion to release documents not harmful to the interests of the State or the owner of the document. However, the IPART Act contains no provisions allowing IPART to release information of its own volition.

## A.2 National Electricity Code

Post 2000, IPART will regulate the electricity distributors under the National Electricity Code and the IPART Act will cease to apply. The Tribunal's information-gathering powers under the current version of the code will be substantially weaker than its current powers under the IPART Act. The code provides that a network owner must submit certified annual financial statements to the Regulator on its economic performance and on the value of its network assets and connection assets. The Regulator may undertake an independent verification of these statements. There is no other power given to the Regulator to gather information under the code and, as discussed below, this information must be treated as confidential. The ACCC (which will regulate transmission prices under the code) is given power to ‘require a Transmission Network Owner to provide any other information the ACCC reasonably requires to perform its regulatory function’.

The ACCC has acknowledged the inadequacy of the code. In its review of the code the ACCC has required code amendments to provide regulators with adequate information-gathering powers.

### Confidential information

Under the National Electricity Code, the underlying principle is that all information must be treated as confidential and not released. However, there is an exception if a relevant State law allows for confidential information to be released.

## A.3 National Gas Code

The proposed national gas laws have much wider information gathering powers. Under the proposal, 'if the relevant Regulator has reason to believe that a person has information or a document that may assist the Regulator in performance of any of the Regulator's prescribed duties under this Law, the Regulator may require the person to give the Regulator the information or a copy of the document.' Penalties for non-compliance are a fine of up to $10 000 and/or two years imprisonment.

The proposed Gas Law will also give regulators general powers to monitor compliance with the code and to gather information relating to the bringing of proceedings under the code. These last two are important because a distinction can often be made between the Regulator's prescribed duties in legislation and more general duties such as monitoring compliance.

### Confidential information

Under the proposed national Gas Law, the power to release information is wider. Documents can be made publicly available even if commercially sensitive or confidential if the public benefit in releasing them outweighs the detriment to the person concerned. This is comparable with the tests for release of documents applying to Victoria's Office of Regulator General.

## A.4 Licences

It has been suggested that provisions of both the electricity and gas codes could be supplemented by licence conditions. Agreement to requirements for information provision and disclosure could be made a condition of obtaining a licence. However, this may be a less preferable option.

Firstly, inclusion in the licensing requirements may be less transparent than inclusion via legislation (e.g. IPART Act) or in codes. Secondly, licence conditions may be more subject to change. This has the merit of being more adaptable to changing circumstances. However, it provides a less certain basis for future utility operation and regulation. Where the licensing body is also the regulator, utilities may be concerned that this would provide excessive power to the regulator. Finally, it is less likely to result in uniform information provision and disclosure requirements across jurisdictions.

# Appendix B. Information collected by IPART and ORG

## B.1 IPART's regulatory accounting requirements for electricity distributors

IPART's regulatory accounting requirements[8] provide that each distributor must prepare profit and loss account, partial balance sheet and cash flow information plus supporting information including five year capital expenditure forecasts by asset type for the following business segments:

? regulated network business;

? unregulated network business;

? regulated retail business (i.e. franchise customers); and

? unregulated retail business (i.e. contestable customers).

IPART requires the regulatory statements to provide an audit trail to evidence the disaggregation of the audited financial statements into the business segments. The disaggregation of the audited financial statements should be based on the principles contained in the Accounting Separation Code[9]. In general, revenue and cost items are to be allocated on a causation basis by identifying the following relationships:

? a directly traceable cause and effect relationship with the provision of the product or service; or

? a verifiable relationship exists between the item and the output of the individual product or service; or

? a cost has a direct causal relationship associated with a pool of common costs and allocation of that pool can be made using a relevant, reliable and verifiable factor such as relative use.

In general, cost items which are directly attributable to the business segments are assigned accordingly. Items indirectly attributable will be allocated to business segments using an appropriate allocating factor.

Cost allocation rules will apply to transfer pricing between business segments. The key principle is that cost should be allocated in relation to the way resources are consumed. Indirect costs that are directly consumed by, or can be allocated to, activities which in

8 A copy of the regulatory accounting requirements can be obtained from IPART tel 02 9290 8448.

9 Prescribed allocation methods are set out in Table B (Corporate operating expenditure allocations), Box B1 (Labour on costs), Box B2 (Stores operation), Box B3 (Motor vehicle/mobile plant expenses), Box B4 (Engineering and technical) of the Accounting Separation Code.

turn can be related to a supply, work or service on the basis of consumption of the activity (e.g. IT resources used by an activity) attributable, are allocated to business segments using an appropriate indicator.

IPART requires a Director's Responsibility Statement to be attached to a Distributor's Regulatory Accounting Statements, stating that the regulatory accounting statements and supporting schedule are fairly presented in accordance with the Accounting Separation Code and associated Regulatory Information Requirements. The Director's Responsibility Statement should be signed and dated by no less than two Directors of the Distributor.

IPART also requires distributors to appoint a Reporter. The Reporter should report that in its opinion:

- Appropriate systems are in place to enable the Distributors to comply with the Accounting Separation Code and this Guideline. (Any weaknesses in the system should be detailed).

- Information submitted with the Regulatory Accounts complies with the policies and principles detailed in IPART's Guideline and the Australian Accounting Standard where appropriate.

To enable IPART to receive explanations or information concerning the Reporter's work in connection with his or her opinion on the Regulatory Accounting Statements, IPART requires distributors to allow IPART to meet, in the presence of the distributor, with the Reporter responsible for the Distributor's Regulatory Audit Report.

- The regulatory accounting requirements were introduced for the financial year 1996/7.

## B.2 Office of Regulator General's Electricity Industry Guideline No 3 Regulatory information requirements

ORG's guidelines require that each distributor prepare profit and loss account, partial balance sheet and cash flow information plus supporting information by the following business segments:

- regulated by price caps;
- excluded services segment;
- other activities;
- retail activities;
- non-specified business; and
- not allocated.

The Guidelines require that accounting principles and policies be selected and applied by a distributor:[10]

- such that there is a recognisable and rational economic basis that underlies their utilisation; and

- in a manner that ensures that the resultant financial information satisfies the concepts of relevance and reliability, thereby ensuring that the substance of the underlying transactions and events is reported.

ORG also requires a Director's Responsibility Statement and the regulatory accounts to be audited subject to agreed audited procedures.

10 Electricity Industry Guideline No. 3, section 3.1.1, ORG.

# Appendix C. Proposed minimum information requirements

## C.1 Category 1: General company information

List of all associated/affiliated companies with a description of scope of activities (regulated and unregulated)

Description of how ring fencing works within the organisation

Current organisation chart

Description of how services are charged between related business units, ie transfer prices

Corporate plan

Performance Agreement with Shareholders or Statement of Corporate Intent

Description of asset valuation methodology for financial reporting purposes, and for regulatory purposes, if different

Description of cost allocation methodology

Cost of supply methodology

**Categories 2 to 6**

The required information as depicted in categories 2 to 6 for the year end 30 June 199X must be supplied for each business segment within the regulated company plus for the company as a whole, split by regulated and unregulated businesses.

The disaggregrated accounts must reconcile back to the audited statutory accounts.

The disaggregrated financial accounts must also be audited.

A Directors' responsibility statement should accompany the accounts.

For example category 2 to 6 information would be collected for the distribution company as a whole, for the network regulated business, network unregulated business, retail supply — regulated business, and the retail supply unregulated business.

Category 2 to 6 cost and revenue data would also be collected for particular customer classes or groups as well as for all customers

Information covering the regulated businesses contained in categories 2 to 6 would be expected to be publicly disclosed.

## C.2 Category 2: General financial information

Profit and loss account — current year plus five year forecasts

Balance sheet — current year plus five year forecasts

Cash flow — current year plus five year forecasts

Capital expenditure forecasts — 20 years

Debt and interest profiles — plus 10 year forecast

## C.3 Category 3: Information on pricing principles and access

Revenue analysis, indicating the amounts and proportions of revenues derived from each customer class and each type of charge (fixed, demand, volumetric)

Customer profiles with average/typical bills, indicating the number of customers of each class and the contribution of each class to system peak, total load, etc.

Cost of supply methodology

Pricing methodology — a description of the methodology used to derive prices

## C.4 Category 4: Information on capital costs

Asset values for each pricing zone, service or category of asset — historical and DORC

Identification of any assets that are shared between the regulated business and other non-regulated business units and the basis of allocation

Details of contributions for capital works — past and future

Assumptions on economic life of asset for depreciation

Depreciation

Accumulated depreciation

Committed capital works and capital investment

Description of nature and justification for planned capital investment

Rates of return — on equity and debt

Capital structure — debt/equity split assumed

Equity returns assumed — variables used in derivation

Debt costs assumed — variables used in derivation

## C.5 Category 5: Information on non-capital costs

Details of cost of goods/services sold

Staff numbers

Wages and salaries — by pricing zone, service or category of asset

Operating costs by major function

Marketing costs

Total overhead costs

Allocation of non-capital costs between regulated and non regulated segments

Provisions

Materials and supply

Taxes

Allocation of non-capital costs within the regulated business by pricing zone, service or category of asset

## C.6 Category 6: Information on operational performance, system capacity and volume

Description of system capabilities

Map of network

System load profile

Relevant non financial performance statistics covering safety, quality of supply and reliability of supply — for example number of outages both planned and unplanned, average outage times, customer connection time

Number of customer complaints by year since the last review, by major category (e.g. service quality, bill too high, price structure)

A copy of the results of the most recent customer satisfaction survey

# Contacts

| | | | |
|---|---|---|---|
| ACCC | Regulators Forum issues | Joe Dimasi | (03) 9290 1814 |
| | Newsletter | Katrina Owers | (03) 9290 1915 |
| | Telecommunications | Michael Cosgrave | (03) 9290 1914 |
| | Airports | Margaret Arblaster | (03) 9290 1862 |
| | Electricity | Michael Rawstron | (02) 6243 1249 |
| | Gas | Mark Pearson | (02) 6243 1276 |
| | Internet address | http://www.accc.gov.au | |
| NSW | IPART | Professor Tom Parry | (02) 9290 8411 |
| | Internet address | http://www.ipart.nsw.gov.au | |
| VIC | ORG | Dr John Tamblyn | (03) 9651 0223 |
| | Internet address | http://www.reggen.vic.gov.au | |
| TAS | Govt Prices Oversight Commission | Andrew Reeves | (03) 6233 5665 |
| | Internet address | http://www.gpoc.tas.gov.au | |
| | Office of the Tasmanian Electricity Regulator | Andrew Reeves | (03) 6223 5665 |
| QLD | Queensland Competition Authority | John Hall | (07) 3222 0500 |
| WA | Office for the Gas Access Regulator | Dr Ken Michael | (08) 9213 1900 |
| | Internet address | http://www.offgar.wa.gov.au | |
| | Office of Water Regulation | Dr Brian Martin | (08) 9213 0100 |
| | Internet address | http://www.wrc.wa.gov.au/owr | |
| SA | SAIPAR | Graham Scott | (08) 8226 5788 |
| | Internet address | http://www.saipar.sa.gov.au | |
| | Electricity Reform and Sale Unit | Patrick Walsh | (08) 8204 1287 |
| | Office of Energy Policy | Dr Cliff Fong | (08) 8226 5512 |
| ACT | Chief Minister's Dept, Office of Financial Management Economics Branch | Ian Primrose | (02) 6207 5904 |
| | IPART | Paul Baxter | (02) 6830 4593 |