

Submission to the Ministerial Council on Energy - Expert Panel

Re: Draft Report on Energy Access Pricing



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Distribution**

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1 Introduction

The Expert Panel (hereafter the Panel) has undertaken an extensive review of energy access pricing and has made a number of draft recommendations many of which are supported by United Energy Distribution (UED). However, UED has a number of concerns with some of the recommendations in particular the issue of:

- reducing the costs of regulation;
- the risks of underpricing versus overpricing;
- that market power of distributors is substantial in practice;
- the use of the Propose/Respond model and the use of “regulatory ranges” ;
- the role of allocative and other efficiency measures;
- the role for the objective and aspects of the framework for regulatory decision making; and
- the new information powers.

2 Reducing the Costs of Regulation

UED notes that the Panel has stated that a “key theme in the Panels terms of reference is to advise upon any measures that may reduce the cost of regulation, while maintaining its effectiveness”. UED considers that the Panel has come some way to achieving its objective in the proposals for basing regulation on the level of market power and for the introduction of Total Factor Productivity (TFP) as a regulatory alternative to the Building Block’s model which is over concerned with the search for efficient costs and rates of return.

However UED is concerned with the Panels lack of a program to reduce the costs of regulation while maintaining its effectiveness. UED is also concerned about the Panels lack of concern with servicing customers and the role of dynamic investment that is an essential part of an innovative approach to customer service.

UED also considers that the Panel should adopt a wider spectrum of alternative regulatory models that can be applied. This is important because while the level of regulation is linked to the potential abuse of market power there will be sectors that remain on the ‘control’ model. Thus it becomes important to also reduce the costs of regulation to such sectors.

UED submits that there are extensive problems with the Building Block model that has been referred to by the Productivity Commission as:

The approach is clearly highly information-intensive and intrusive, which participants claimed reduces incentives for good performance. Specifically, it requires the regulator to:

- seek extensive information about a facility’s existing and forecast costs, including of any services not regulated (to prevent cost shifting);

- judge whether operating and maintenance costs are based on efficient service delivery; and
- seek information about planned capital expenditure and judge whether that expenditure is justified. This is because capital expenditure will increase the asset base and, therefore, the allowed dollar rate of return.

The need to forecast future costs, and to validate proposed capital expenditure, could lead to the regulator having a significant influence over the running of the business. Such outcomes illustrate the tendency for price caps based on the building block approach to suffer from some of the disadvantages of rate of return regulation

Moreover, subsequent efforts of the regulator to address the downsides of rate of return regulation — incentives to ‘gold plate’ assets and pad costs — could in turn lead to even more intrusive regulation of the sort noted by APAC. In other words, the regulation can feed off itself.¹

This uncertainty has also been reflected in legal decisions. For example the Australian Competition Tribunal in the *Duke Eastern Gas Pipeline* stated:

This argument does not take sufficient account of the fact that regulation is a second best option to competition. The complex nature of the tariff-setting process, the number of assumptions it relies on, and the fact that the reference tariff is a publicly available price which may be varied by negotiation between the pipeline owner and user depending on the user’s requirements and conditions in the marketplace, all point to the fact that the reference price is not necessarily the price which would result from competition.²

Given these concerns UED considers that the Panel could have gone further in reducing the costs of regulation while maintaining its effectiveness. In this context the Panel referred to a submission which attempted to accomplish this:

Two submissions suggested that where a regulated entity had been through two building block price reviews there should be a presumption that an alternative method could apply, given that efficient costs would be already known.³

While the Panel did not further consider the implications of this proposal to simplify the regulatory regime UED considers these are worth exploring given the concerns expressed by the Productivity Commission about the information intensive “Building Block” model.

UED submits that an approach could be developed which meet the Panel’s objective to reduce the costs of regulation while maintaining its effectiveness. This was because their costs would be efficient and the only concern would be with prices being abused in a price monitoring model. While UED would argue the Panel is over concerned about the actual ability to exert market power there is another regulatory option for such companies that have efficient costs.

¹ Productivity Commission, Review of the National Access Regime, Inquiry Report No. 17, 28 September 2001, p.

² Australian Competition Tribunal: *Duke Eastern Gas Pipeline Pty Ltd* [2001] AcompT 2 [110]

³ Expert Panel on Energy Access Pricing, Draft Report to the Ministerial Council on Energy, March 2006, p.37.

The Panel has identified the following forms of regulation that it considers to be most appropriate for application to electricity and gas infrastructure services that continue to come within the scope of regulation:

- Direct price or revenue controls (control);
- Commercial negotiation with dispute arbitration (negotiate/arbitrate);
- Price monitoring and reporting (monitoring); and
- No regulation.

However, the Productivity Commission has determined that regulators broadly have three instruments to control or influence prices:

- setting access prices for individual services;
- price or revenue caps covering a range of services; and
- price monitoring.⁴

UED is surprised that the Panel did not consider price caps as a regulatory option between building blocks and price monitoring. The Productivity Commission considered that a price cap could apply as an alternative to Building Blocks regulation under certain circumstances.

For example, the Productivity Commission refers to the Australian Competition and Consumers Commission (ACCC) who noted that price and revenue caps can potentially promote efficiency in three ways:

- they can ensure that facilities do not price too far in excess of costs;
- they can provide firms with an incentive to seek cost savings in excess of those needed to fall within the cap; and
- they provide a facility with the freedom to structure its prices so as to recover common costs in the most efficient way.⁵

The Productivity Commission also refer to a submission from the ACCC which considers that price caps are the instrument of choice for regulating access to vertically separated facilities:

Incentive regulation in the form of price caps can combine the clarity and certainty advantages of tariff setting and at the same time provide incentives for the service provider to reduce production costs. As such, and given that most of the services regulated by the Commission using Part IIIA are vertically separated, there is a strong case for using price caps in regulating terms and conditions of access (sub. 25, p. 83).⁶

⁴ Productivity Commission, op cit p. 340.

⁵ Ibid, p.341

⁶ Ibid, p.341

However, while the incentive provided by price caps to seek cost savings is strength, like other forms of price control, it also places a requirement on the regulator to monitor service levels, or impose service quality standards. Otherwise, cost savings may be made by cutting service levels, rather than by increasing efficiency.

UED submits that the Panel should consider price caps as a new regulatory control model on the basis that it would:

- only be available to distributors who had been through two price reviews;
- be a regulatory option in the context that the distributors could propose this methodology before the start of a building blocks price review;
- involve a regular review of service standards to ensure that current service standards are maintained;
- involve an regular benchmarking study of cost to ensure that costs remained efficient; and,
- continue as a CPI adjusted real price unless real interest rates changed substantially.

This model is based on the existing practices of regulators when operational costs are continued across regulatory periods only for differences. Distributors would only be able to open a price cap (aside from a major change in real interest rates) if operational costs changed due to safety or other state based legislation (eg road maintenance) or a major problem occurred with the network . These would all require the approval of the regulator.

Such an approach would be appropriate for both electricity and gas distributors as the rate of cost reducing technological change is relatively low in both sectors and given that all managerial type productivity improvements would have been taken over the last two regulatory periods (ten years duration).⁷

UED recommends that a new regulatory option (price caps) is approved by the Panel and that this should only be available to distributors who have been through two price reviews.

3 The Conflicts with the Trade Practice Act

In terms of under and over recovery the Panel advocates the view that:

The Panel considers a more complete response to the potential for regulatory error (and the possibility of asymmetric consequences) is to ensure that the objective for the regulator is appropriate, the guidance is clear and that the mechanisms in place for review of the regulator's decisions are appropriate. In addition, the Panel considers that the guidance to the regulator would be improved by the requiring the AEMC – in making the Rules that are applied by the AER – to have regard to the risks and costs of:

- potential for under- and over-investment in assets by the regulated distribution or transmission system operator; and

⁷ This is especially the case with an efficiency carryover operating.

- potential for under- and over-utilisation of the capacity of assets forming part of a distribution or transmission system, and the capacity of proposed new assets. (page 71)

This equal weight applied to under and over investment is quite a change to the accepted view that the costs of under recovery outweigh the costs of over recovery. For example, the accepted view that under recovery is the largest risk is advocated by the:

- Productivity Commission in the National Access Inquiry;
- Productivity Commission in the Gas Access Inquiry; and
- Australian governments in the establishment of new Pricing Principles for the National Access Regime in the Trade Practice Act.⁸

Moreover, the Panel's recommendation is at odds with the proposed Pricing Principles to be introduced in Part IIIA and to form part of the certification criteria within clause (6)(4) of the Competition Principles Agreement. However, the Panel proceeds on the assumption that this is not a barrier to its recommendations as the new Pricing Principles as part of the certification criteria will not apply to energy markets:

With respect to the second of these, the new objects clause and pricing principles in Part IIIA will not directly affect the certification criteria. However, at its meeting on 10 February 2006, COAG agreed to amend clause 6 of the CPA so as to require the inclusion of an objects clause and pricing principles in equivalent terms to those which are to be incorporated in Part IIIA. These requirements are reflected in clauses 2.4 and 2.5 of the Competition and Infrastructure Reform Agreement. However, clause 1.3 of that Agreement provides that these requirements are taken to be satisfied in respect of the access regimes for electricity and gas which are to be developed and certified in accordance with the Australian Energy Market Agreement.⁹

UED does not agree with the Panel's assumption and instead considers the energy access regimes will need to comply with the certification criteria in the Competition Principles Agreement (CPA) (as amended in accordance with the Competition and Infrastructure Reform Agreement (CIRA)).

Clause 1.3 of the CIRA provides that "the access regimes for electricity and gas which are developed and certified in accordance with the Australian Energy Market Agreement...will be taken to satisfy the requirements of clause 2 of this agreement". UED makes these points:

- a) The Australian Energy Market Agreement (AEMA) does not in fact deal with the development and certification of the access regimes for electricity and gas. Thus, technically, there is nothing that falls within the scope of the operation of clause 1.3;

⁸ The new pricing principle in the Trade Practice Act and the Competition Principles refers to the concept of providing "revenue that is at least sufficient to cover efficient costs" (underline added). The term is designed to err on the side of the regulated infrastructure business given the risks of long term investment from underpricing and has been adopted from the Productivity Commission's Inquiry into the National Access Regime. The Commission considered the clause to "set a relatively clear floor to revenue allowed within an access regime to facilitate investment in the essential service" (p.330)

⁹ Draft Report to the Ministerial Council on Energy, Expert Panel on Energy Access Pricing, March 2006, p.19

- b) In so far as it would appear that clause 1.3 indicates a misconception that the AEMA in some way already dealt with the class of matters in clause 2 of the CIRA, it can be expected that once that misconception is corrected the Governments will not amend the CPA to exempt the energy access regimes from the requirements of clause 6(4) of the CPA;
- c) As such, the energy access regime will need to meet the requirements of clause 6(4) of the CPA, including the objects and pricing clauses in clause 2.4 of the CIRA, to obtain certification.

So acceptance of the Expert Panel's recommendations will mean either that:

- If the panel's assumption is correct, energy businesses will be subject to a different approach to access regulation compared to other infrastructure businesses which are also capital intensive and subject to the same long term investment problems as energy companies which would be a peculiar policy outcome; or
- If UED's view is correct, the energy access regimes will not meet the criteria for certification.

Under recovery and Over recovery

This issue of the costs of over versus under compensation drives much of the Panel's regulatory approach including the use of the Consider - Decide model and the rejection of the regulatory ranges concept. However, UED considers that this issue has not been adequately dealt with by the Panel. In particular the issue of the costs of underpricing being equal to the costs of over-pricing is dependent on the:

- actual market power of infrastructure owners and whether this power is constrained; and
- consequences of under and over compensation being asymmetric in the long term given the new objective in the National Electricity Law (NEL) and the National Gas Law (NGC) refers to the "long term".

The Panel argued that constraints on the market power of distributors mean a lower level of regulation should apply:

It is the potential for social loss from inefficiency that motivates the regulation of energy network services that exhibit substantial market power. As a general proposition, the greater the market power and the greater potential efficiency loss from its use, the greater the likelihood that more intrusive forms of regulation (such as direct control of prices) will improve market outcomes. Conversely, where market power is less substantial, and so the lower is the potential inefficiency loss, the stronger is the case for less intrusive forms of regulation or no regulation at all.¹⁰

¹⁰ Ibid, p.35.

4 The Issue of Market Power

The Panel's basic assumption which drives their approach to regulatory models is that the societal costs of over recovery are equal to the costs of under recovery. The Panel considers that the market power of distributors is "substantial" and that therefore the costs of over recovery are equal to the costs of under recovery (underline added).

In this context of this area the Panel argues that:

In many essential infrastructure service markets, the type of technology, the diminishing marginal costs of use within capacity constraints and the lumpy and fixed nature of the assets (irreversible or sunk investment) dictate that one supplier rather than two or more can provide the service at least cost. Thus, while supply by one infrastructure operator represents the most efficient market structure, the natural protection available against competitive entry confers substantial market power on the incumbent. In short many of these services are a form of natural monopoly. The owner of these assets has both the capacity and the commercial incentive to take advantage of this market power at the expense of the users of the service. Access regulation aims to capture the efficiency benefits of provision by a single entity, but reduce the risks of the efficiency losses arising from substantial market power.¹¹ (Underline added)

UED considers that the argument that essential infrastructure possesses "substantial" market power is relying on a textbook view of economics. There are a number of constraints on the market power of distributors that are exogenous to the distribution sector and that might constrain the ability of a network owner to exercise market power, including the:

- bargaining power of users;
- price elasticity of demand for distribution network services;
- amount of expenditure on distribution services;
- availability of substitutes; and
- type and extent of the market.

In such circumstances where market power is constrained, a service provider faces commercial incentives to operate efficiently by focusing on increasing throughput. If the constraints on market power are large enough the regulatory regime does not have to be concerned so much with market power as a reason for a heavy handed regulatory model. It is therefore important to consider the practical issues in regard to whether distributors can exert substantial market power and this is set out below.

The Panel support the proposition that constraints on market power would mean a more light handed regulatory model could be introduced:

Where these circumstances are present users are in a position to protect themselves from the potential for service providers to exercise market power and to negotiate more economically efficient prices and conditions of access. In these market circumstances,

¹¹ Expert Panel, pp 8-9.

less intrusive forms of regulation (e.g. negotiate/arbitration or price monitoring) would be more appropriate than direct price or revenue cap regulation.¹²

It is the potential for social loss from inefficiency that motivates the regulation of energy network services that exhibit substantial market power. As a general proposition, the greater the market power and the greater potential efficiency loss from its use, the greater the likelihood that more intrusive forms of regulation (such as direct control of prices) will improve market outcomes. Conversely, where market power is less substantial, and so the lower is the potential inefficiency loss, the stronger is the case for less intrusive forms of regulation or no regulation at all.

Bargaining power of users

The Productivity Commission argued that

The bargaining power of users might constrain the market power of distribution network owners. On a network where a large proportion of gas is used by large industrial customers, the bargaining power of these customers is relatively significant, especially when they have substitution possibilities such as building a spur line from a transmission pipeline.¹³

The Productivity Commission also quoted the submission by Alinta/Multinet which noted circumstances in which the bargaining power of the distribution sector for gas and electricity might be constrained by the market structure:

- independent retailers attached to distributors could provide a countervailing power to monopoly price increase, especially if they were price capped;
- distribution prices flow through retailers and to final customers, all of whom can monitor and object to price increases and produce a countervailing power to monopoly prices; and
- even with an associated retailer a distributor would be constrained from increasing prices by larger customers, industry associations, lobby groups and the media.¹⁴

These are particularly important as a constraint on the power of electricity and gas distributors. Given that price increases would be clearly noted by retailers and affected businesses it is more highly likely that there would be complaints to the ACCC. The ACCC would find actions for abuse of market power easier to take in the energy area as the market is easily defined and the existence of market power more easily argued.

Price elasticity of demand

A service provider facing a low price elasticity of demand for distribution services has greater ability to exert market power because it can increase its price without revenues falling. Typically, elasticity of demand is higher in the long run.

¹² Expert Panel, p.43

¹³ Productivity Commission, Review of the National Gas Regime, Report No. 31, 11 June 2004, p.45

¹⁴ Ibid, p.46

The demand for distribution services is directly related to the demand for natural gas and electricity. In the commercial and industrial sectors, the demand for distribution services (as with transmission services) is a 'derived' demand. In the residential sector, the demand for distribution services is akin to demand for a consumption good. The price elasticity of demand is thus mainly influenced by the:

- proportion of consumers' income spent on the consumption good; and
- availability of substitutes.

Residential customers use natural gas predominately for space heating, water heating and cooking. This extent to which customers use gas for particular purposes varies around Australia. In warmer climates, for example, gas is used less for space heating as consumers are more likely to use alternatives such as electric reverse cycle air conditioning. These market effects can operate to reduce the market power of both gas and electricity distributors.

Proportion of consumers' income

The larger the proportion of consumers' income spent on a good, the more elastic is the demand. The Productivity Commission in the Gas Access Regime Inquiry argued that:

Even though the cost of distribution is around 70 per cent of the costs of supplying natural gas to residential users (figure 2.6), it appears to account for a relatively small share of consumers' income. In 1998-99, the proportion of consumers' expenditure (not income) spent on domestic fuel and power was 2.6 per cent (ABS 2000). This proportion will vary by State and Territory. In Victoria, consumers are likely to spend a more significant proportion of their income on natural gas consumption (due to the cold weather) and, therefore, will be more sensitive than users in warmer States, such as Queensland, to a price change. While the proportion of consumers' income spent on natural gas distribution might be relatively small, the effect on the elasticity of demand can be overshadowed by the availability of close substitutes.¹⁵

The issue of substitutes is analysed below.

Availability of fuel and energy substitutes

The extent to which fuel and energy substitutes exert competitive pressure on the distribution sector depends on the ease with which a consumer can replace natural gas with another fuel or energy source for a particular purpose, and on the substitute's price relative to the price of natural gas. The Productivity Commission argued that residential users can readily replace natural gas (especially in the long run) with:

- electricity, wood and LPG — for space heating
- electricity, LPG and solar power — for water heating
- electricity and LPG — for cooking.

¹⁵ Ibid, p.48

Relative prices play an important role in determining the extent to which these substitute fuels and energy sources exert competitive pressure on particular gas distributors but also electricity distributors. The Productivity Commission also concluded that electricity is an important competitor to natural gas:

The competitive pressure exerted by electricity off-peak tariffs is particularly significant:

... gas competes with electricity, in particular with the electricity-heating tariff, which is generally relatively low as it is off peak. (Alinta/Multinet, sub. 36, p. 20) Substitutability between gas and electricity is quite high. Maybe 7 to 10 per cent of consumers change their energy source at any particular point in time. Certainly if a gas distributor can't hook up two services, which is heating and cooking, then it's probably not economic to connect a gas distributor, that is. So gas distributors compete against the electricity hot water tariff and that tends to be low peak and relatively low so if you can't get substantially under that electricity hot water tariff then you probably won't be successful in getting a customer. (Alinta/Multinet, trans., p. 201)

The Productivity Commission also concluded that the competitive pressure exerted by electricity is ongoing, because although individual customers might be locked into using a natural gas appliance for around 10–15 years, around 7 per cent of consumers change appliances every year:

Customers can make decisions regarding substitute products when selecting or updating their capital equipment or appliances. This is particularly the case with new extensions where households are choosing their energy source and can trade off costs and benefits of alternative sources of energy. At any time this may affect some 7 per cent of consumers who are new households or are replacing equipment and may provide some constraint on the exercise of market power in electricity or gas pricing. (Alinta/Multinet, sub. 36, p. 20)¹⁶

Electricity has a number of advantages over the supply of natural gas. While electricity can be used in all the purposes for which gas is used, gas cannot always replace electricity (for example, a computer cannot run on gas). The market penetration of electricity is nearly 100 per cent, meaning significant economies of density can be exploited in this sector. The Productivity Commission outlined the advantages of electricity over gas:

- gas is a fuel of choice that is not automatically provided to all properties; unlike electricity, gas must be reticulated in new subdivisions at the cost of the network owner;
- gas appliances and installation are generally more expensive than their electrical counterparts;
- arranging gas connection and appliance installation is more complex (for example, fluing is normally required indoors in contrast to electrical appliances that can be plugged into a power point); and
- there are a greater range of electrical appliances (and electrical retailers) available.¹⁷

¹⁶ Ibid, p. 48

¹⁷ Ibid, p. 49

Even though electricity distribution has more market power than gas distribution given the above arguments electricity distributor's market power is still constrained by the competition for gas in the hot water market and this can play out differently in states with different levels of gas demand.

Differences across States and Territories

For natural gas distributors attempting to penetrate a new market, the competitive pressure exerted by substitute fuels and electricity is particularly significant as demonstrated by the Tasmanian example:

For example prices will largely be determined by competition from competing fuel sources within the Tasmanian energy market. In regard to gas sales in such markets, natural gas is simply one energy source within the competitive energy market, competing against other forms of energy such as electricity, coal, fuel oil, LPG and wood. Therefore, it will be necessary for gas distribution access charges to be competitive within this energy market. In this environment, the gas distributor will not have market power within the overall energy market, even where it has an exclusive right to distribute natural gas, due to competitive pressure from other energy sources.¹⁸

The extent to which market power is constrained for a distribution network will differ according to the number and type of users of that network. The number and type of users varies across networks. In Queensland for example, where the number of users of the distribution networks is relatively low:

- the reliance on large industrial or commercial customers is significant
- the unit price of gas is higher.

The market power of distributors in Queensland might be considerably constrained, therefore, by the bargaining power of users and the competitive pressure exerted from other fuel and energy sources. In contrast, in Victoria — where the number of users of the distribution network is relatively high and a significant proportion of the natural gas transported in the distribution network goes to small residential customers — the bargaining power of users and the competitive pressure exerted by other fuels might not have as significant an impact on the market power of distributors in Victoria. However, as argued above price increases are noticed by retailers, large customers, industry associations and customers generally and they could and would report price increase to the ACCC who would investigate the matter.

The Productivity Commission in the Gas Regime Inquiry found that:

Distribution networks have natural monopoly characteristics. The scope for distribution network owners to exercise market power arising from such characteristics can be constrained by a number of factors, including the availability of other fuel and energy substitutes. The extent to which market power is constrained differs across networks. A network owner servicing a new market (or one in which use is low) generally has little market power.

¹⁸ House of Assembly, Parliament of Tasmania, 29 May 2003, cited in ACCC, sub. 48, p. 20

In addition the Panel also noted that gas was less of a risk in term of abusing market power:

“Gas and electricity markets also display different characteristics in terms of price elasticity of demand and the ability for consumers to seek substitutes... This inelasticity reflects the essential nature of electricity to commercial and industrial activity and to modern life. This is less so for gas which is considered to be a ‘fuel of choice’, meaning that it is subject to more competition from substitutes.”¹⁹

This conclusion on gas distributors can be extended to electricity distributors as discussed above and as such the ability to exert “substantial” market power by both sectors given actual market conditions is unlikely. This is especially so when considering the interconnected nature of the energy industry, the better education of industry participants about market power and the relative ease for the ACCC to take the necessary action. As such UED argues that the reason for the Panel’s model of basing regulation on the “substantial” amount of market power should be modified in light of this argument.

5 The Issues of Under or Over Recovery of Costs

The previous section above dealt with the issue of the market power of distributors and showed that their market power was constrained – substantially for gas distributors. This section considers the economic effects of under and over recovery and which view is likely to be correct.

UED considers that while the elimination of monopoly rents is an objective of sound economic policy, there are also strong economic reasons to place a greater emphasis on ensuring incentives for efficient investment and for continued productivity growth than on ensuring low access prices *per se*. The Panel report places overwhelming emphasis on the elimination of monopoly rents, but UED contends that the more serious problem is the potential for regulation to result in under-investment in infrastructure.

The Productivity Commission in the National Access Inquiry argued strongly that the costs of under investment were the most serious:

Regulators must operate with limited information and imperfect regulatory tools. This implies that precise delineation after the event between genuine monopoly rents and balancing upside profits on successful projects will be well nigh impossible. Accordingly, even an ‘unbiased’ regulator could sometimes allow a service provider to retain an element of rent, and sometimes truncate balancing upside profits

Some participants, including the NECG, argued that there is an asymmetry in the consequences of the two types of error, with under-compensation for service providers likely to be more costly for the community than over-compensation. In essence, the underlying proposition was that the cost conditions for natural monopoly facilities are such that the prospect of under-compensation can lead to non-provision of services. In contrast, over-compensation reduces, but does not eliminate, use of those services. Specifically, the NECG commented that:

In using their discretion, regulators effectively face a choice between (i) erring on the side of lower access prices and seeking to ensure they remove any potential for monopoly rents and the consequent allocative inefficiencies from the system; or (ii)

¹⁹ Expert Panel, p. 43.

allowing higher access prices so as to ensure that sufficient incentives for efficient investment are retained, with the consequent productive and dynamic efficiencies such investment engenders.

There are strong economic reasons in many regulated industries to place particular emphasis on ensuring the incentives are maintained for efficient investment and for continued productivity increases. The dynamic and productive efficiency costs associated with distorted investment incentives and with slower growth in productivity are almost always likely to outweigh any allocative efficiency losses associated with above-cost pricing.

For the reasons outlined above, the Commission does not subscribe to the view that, in a regulated environment, the community faces a choice between incurring the allocative efficiency costs of over-compensation and (more serious) dynamic costs of under-compensation. Both types of error are likely to influence investment outcomes and therefore have dynamic efficiency implications.

Nonetheless, the Commission accepts that there is a potential asymmetry in effects:

- Over-compensation may sometimes result in inefficiencies in the timing of new investment in essential infrastructure (with flow-ons to investment in related markets), and occasionally lead to inefficient investment to by-pass parts of a network. However, it will never preclude socially worthwhile investments from proceeding.
- On the other hand, if the truncation of balancing upside profits is expected to be substantial, major investments of considerable benefit to the community could be foregone, again with flow-on effects for investment in related markets

In the Commission's view, the latter is likely to be a worse outcome. Accordingly, it concurs with the argument that access regulators should be circumspect in their attempts to remove monopoly rents perceived to attach to successful infrastructure projects.²⁰

The issue on over or under pricing is considered in three contexts including the:

- problem of the information asymmetry between regulator and the regulated industry;
- particular nature of regulated infrastructure assets; and,
- consequences of under and over-estimating optimal access prices.

Information Asymmetry

The Panel assumes that a regulator can determine efficient access prices with some certainty. In such cases monopoly rents will be removed, consumption will increase, while sufficient incentives will be retained to ensure that access providers continue to invest efficiently and upgrade their infrastructure. However, as the NECG²¹ argues this is unlikely:

²⁰ Productivity Commission, Review of the National Access Regime, Report No.17, 28 September 2001, pp 82-83.

²¹ The NECG have recently changed their name to CRA International

In practice, such ideal conditions are seldom realized. In the first instance, it is highly unlikely that regulators will have access to sufficient sources of information to be able to accurately determine the social costs associated with the supply of the facility at issue. Cost estimation is a formidable problem for regulators, even when the actual costs of the regulated firm are the focus. It is significantly more difficult to accurately estimate the capital costs of a hypothetical, efficiently configured asset. In either case, crucial cost determinants include the amount of economic depreciation to be allowed and the weighted average cost of capital, neither of which can be reliably estimated without reference to demand for the regulated firm's services.²²

In addition a regulator would require to utilise efficient multi-part pricing to have any chance of setting ideal prices:

This obviously assumes that the regulator can set a multi-part price, so that price at the margin of consumption reflects marginal cost, inframarginal prices do not exclude access seekers who would be willing to cover their incremental costs and prices overall encourage efficient entry decisions. Where multi-part prices are not possible, or cannot be fully efficient (for example, because they will affect entry decisions into downstream markets), then the different types of efficiency can conflict. As a practical matter, it is rarely the case that a price schedule can be determined that will simultaneously support in-period the (allocative) and between-period efficiency in industries with lumpy investments.²³

The NECG also argue that a problem also exists with operating costs:

The estimation of operating costs is not more straightforward. While there is some logic in constraining the earnings of regulated capital to be consistent with those of an efficiently configured asset, this does not apply to operating costs. The firm operates with its actual capital base, rather than the hypothetical one, and can only be expected to minimise the cost of operating the asset.²⁴

In summary the NECG argues that even the best resourced regulator will find it exceedingly difficult to be confident that their estimates of efficient costs are neither too high nor too low. They conclude that the need to establish future efficient costs, given the technical difficulty of doing so, introduces significant uncertainty into the regulatory processes in a number of jurisdictions in Australia.

The Particular Nature of Infrastructure Assets

In infrastructure industries the determination of efficient access prices is more difficult and the consequences of getting access prices wrong can be much greater than in other industries.

The problem for infrastructure industries is that their investments are long lived and sunk and as such present different adjustment paths to under-investment:

In most industries, errors in price determinations are to a larger degree self correcting - or at the very least, market developments rapidly make it clear that prices have been set

²² NECG Submission to the Productivity Commission Inquiry into Part 111A, Submission No. 39, 18 January 200, p. 17.

²³ Ibid, p.17 footnote 16.

²⁴ Ibid, p.17.

at unsustainable levels. Thus, if prices are too low, exit occurs, with the contraction in supply putting upward levels on price levels.

In infrastructure industries, however, these self –correcting mechanisms work less well or at least far less quickly. Even putting aside the fact that price mechanisms are suppressed to a greater or lesser degree by regulation, the difficulties arise from the largely sunk nature of the relevant assets. At any point in time, demand in most infrastructure assets that have low or even negative asset values. Moreover, the holding costs of these assets (that is, the sum of their capital charge and non-use related depreciation) makes up by far the greatest share of the total costs of supply: that is, variable costs are relatively low. As a result, when revenues are forced below the level corresponding to the long term costs of supply, capacity is likely to remain in use, so long as the allowed revenue exceeds the (relatively low) out-of –pocket costs of continued operation.

That is not to say that adjustment will not occur: but it can take many years before the full consequences of revenue inadequacy become apparent. Rather what typically happens, when regulated revenues are driven below long term costs is that service continues – but maintenance is cut back, new investments are deferred, the quality of service suffers, and it is only once the impacts of each of these has cumulated the full extent of the problems become evident.²⁵

The slow nature of adjustment in infrastructure industries means that it is difficult for the regulator to ascertain if prices have been set too low. In addition price reductions are politically and generally popular and this puts further pressure on regulators.

Consequences of under and over-estimating access prices

Given the uncertainty about efficient costs and the problem of the type of infrastructure, policy makers face a choice as to whether the regulator should err of the side of lowering access prices and seeking to ensure that any potential for monopoly rents is removed, or on the other hand, allowing higher access prices in order to ensure that sufficient incentives have been provided for efficient investment with the consequent productive and dynamic efficiencies.

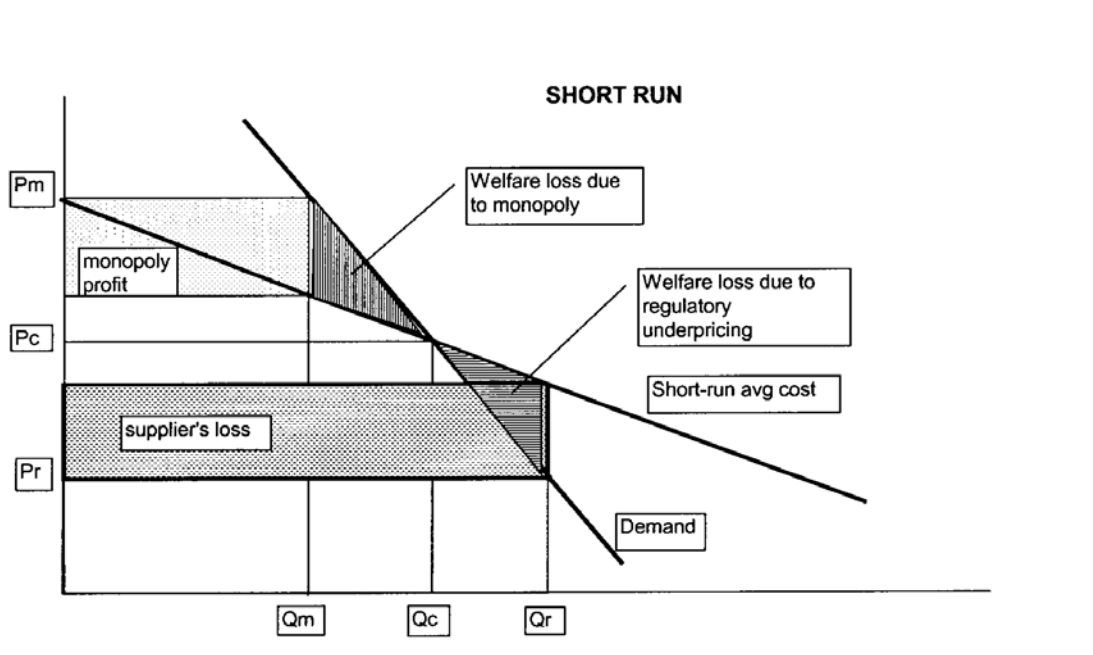
In analysing this area NECG suggest it is important to distinguish between wealth transfers and output restrictions in monopoly businesses:

Commonly, monopoly pricing is attacked because it involves a transfer from consumers to the monopoly producer. However the most serious problem caused by monopoly pricing is the loss of social welfare, which results from the monopolist's profit maximizing restriction of output. There are parallel issues created by pricing below the competitive equilibrium price. When this occurs, output can be higher than the welfare maximizing level and the consumer gains are more than negated by the producer's loss. The transfer in this case is from producer to consumer, but the net welfare effects in the short run for underpricing are negative in exactly the same way as they are for monopoly pricing.²⁶

²⁵ NECG, p. 19-20

²⁶ Ibid, pp. 21-22.

The following diagram is used by NECG to argue the above point.²⁷ The diagram depicts the short run situation, in which infrastructure investments are sunk. The demand curve has the steep slope characteristic of the relatively inelastic demand for essential services. The short run average cost curve displays the gradually decreasing slope typical of infrastructure investments, which often display economies of scale before capacity limits are reached. The NECG note that the conclusions are not dependant if the short run average costs curve has an increasing slope.



PC represents the competitive price at which the service provider earns zero economic profit. Pm represents the monopolistic price, where the service provider earns monopoly rents which result in a deadweight welfare loss to society equal to the triangle with the vertical hatched area.

If instead the price is set at Pr, which is as far below Pc as Pm is above it, then the supplier will make a loss in the short run (given by the rectangular area). This loss is significantly higher in magnitude than the monopoly profit gain from pricing at Pm.

The NECG conclude that:

In the short run, a supplier is likely to continue to provide service even when the regulated price is below its average cost of supply, so long as the price exceeds the variable costs.

At Pr there is also a deadweight welfare loss, given by the area of the lower triangle (horizontal hatching). Under the assumptions used here (i.e. linear demand and supply curves, and $P_m - P_c = P_c - P_r$) this welfare loss is equal to the monopoly pricing welfare loss. In this case the welfare loss arises because some customers ($Q_r - Q_c$) are supplied

²⁷ Ibid, p.21

even though they value the service less than it costs to deliver – scarce resources are being diverted from the supply of the services that customers value more highly – a classic allocative inefficiency.

In this short run situation, overpricing and underpricing by equal amounts relative to the competitive price level are equally damaging to welfare. In the monopoly pricing case there is a transfer of wealth from customers to the supplier. In the underpricing case there is a much larger transfer from the supplier to customers.²⁸

However, in the long run the welfare effects of overpricing and underpricing by equal amounts relative to the competitive price level are not equivalent. UED notes that the proposed objective in both the NGL and the NEL refers to “the long term interests of consumers” and that the long term is the relevant test in which to assess the relative costs of underpricing versus overpricing. The NECG argue that:

In the first place, it is no longer true that in the long run that a supplier would continue to provide service when the regulated price is below its average cost. In the long run, all costs are variable, so a regulated price that is below average cost would be below variable cost.

In the second place, the long run average cost curve may, at the point it is intersected by the demand curve, have a declining, level, or increasing slope, notwithstanding the short run economies of scale of some assets.

If the long run average cost curve were downward sloping or flat, then the consequences of a regulated price which is below the equilibrium level would be very serious from a welfare perspective. There would be no level of output greater than zero at which the supplier could recover its long run variable costs (equal to the long run average costs). Faced with this situation, the supplier would exit the industry when reinvestment was required, or would attempt to modify its long run average costs curve by degrading service quality or investing in assets with low capital costs and high operating costs. If the output level is reduced to zero, then the welfare losses will be maximized.

If the long run cost curve is upward sloping, then the supplier would continue to operate, but at a level of output which was reduced from the competitive equilibrium level by an amount needed to align long run average costs with the regulated price.²⁹

NECG indicate in the following diagram this case where the demand curve is steep reflecting the essential character of regulated infrastructure services. Relative to the competitive equilibrium price at P_c , monopolistic pricing at P_m would lead to a welfare loss equal to the triangle with the cross hatching. The NECG argue that:

However this welfare loss is small compared to the loss arising from underpricing P_r , which is as far from P_c as it is P_m . The welfare loss due to P_r is given by the large triangle (which overlaps the small triangle).

Thus in the long run situation, for a pricing error of a given magnitude, the welfare loss will be significantly greater if the error in pricing is too low rather than too high. This conclusion holds for all average cost curves except those that rise more quickly than demand falls. Such circumstances are unlikely for regulated essential services where

²⁸ Ibid., pp. 21-22

²⁹ Ibid, p.22

supply usually involves large fixed costs and hence declining average costs, and where demand for the essential service is typically inelastic (and hence steep). As has been noted above, the welfare costs associated with low access prices are not immediately apparent, in contrast to the short-term transfers enjoyed by consumers. Nevertheless, economic analysis suggests these future welfare losses are likely to be extremely high.

This conclusion is surely consistent with every day experience. When under- investment leads to poor quality of service or unreliable service, the flow on effects to other businesses and the broader economy are often extremely serious. One only has to remember instances in the past twenty years of blackouts and brownouts, gas supply disruptions, train derailments, or water contamination incidents to appreciate the severe consequences of service interruptions.³⁰

The Panel views the need to preserve investments incentives but only with greenfield sites and ignore mature networks;

“The Panel is keenly aware of the need to preserve investment incentives and to minimise the potential for and consequences of regulatory error. The adverse consequences for the community of regulatory failure to provide adequate returns to an investor are highest when considering major new investments in infrastructure where project risk is considerable and demand growth uncertain. These conditions are most clearly met with respect to major new pipeline or transmission investments linking or creating new markets.”³¹

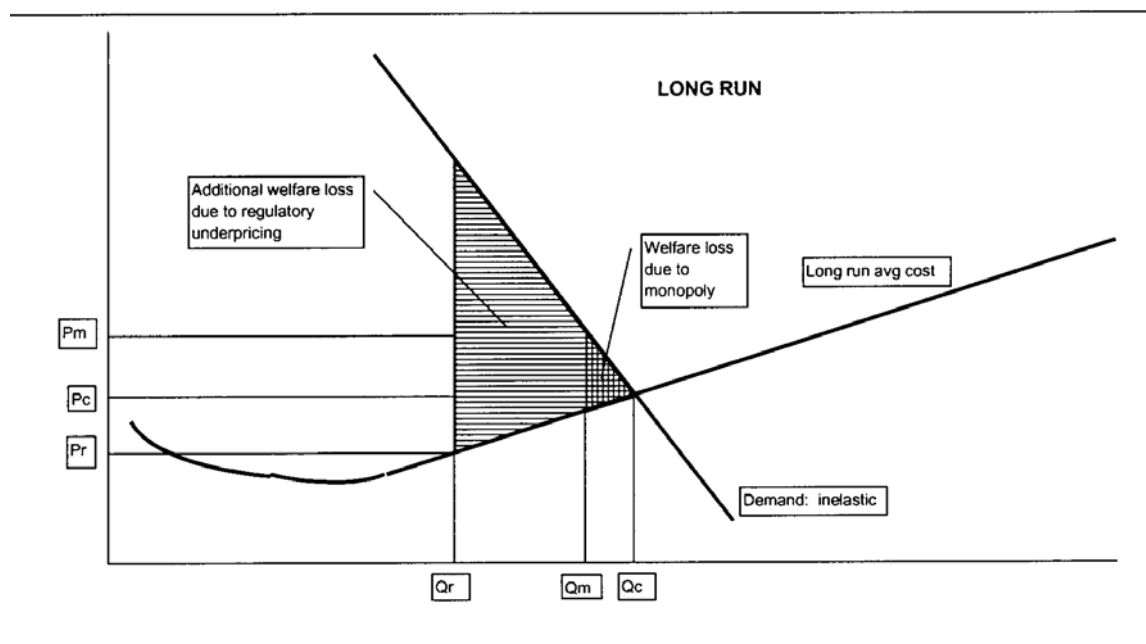
“The Panel considers that the potential for and consequences of regulatory error in relation to mature networks is much less pronounced than for greenfield-type projects. However such risk and cost do exist and there is a need to ensure that the AER has clear guidance designed to reduce the risk and maintain incentives for efficient investment while in particular allowing a proper return on investments necessary to meet prescribed service standards. That said, the balance of risks for investments that have moved beyond the 15 or so year timeframe for greenfield projects, which are the principal focus of regulatory decision making, is not such as to require embedding an upward bias in pricing determinations, particularly along the lines of the Productivity Commission proposal.”³²

This is an odd view given the mature networks serve by far the majority of Australian businesses and residences. To argue that all this sector requires is for the AER to have clear guidelines neglects the clear concerns of the Productivity Commission in two major public inquires about the need to ensure long term investment in regulated infrastructure industries. Continuity of key business and household inputs are often taken for granted, but the rare failures are dramatic and widespread in their impacts. This position is also not supported by the economic analysis presented in this section.

³⁰ Ibid, p.23.

³¹ Expert Panel, p.69

³² Ibid, p. 69-70



This conclusion supports the proposition that both mature networks and greenfield investments need pricing principles that err of the side of ensuring long term investment. This conclusion and the conclusion on the market power discussion in this paper make it more likely that a propose – respond model is required in energy regulation.

6 The Issue of the Propose Respond Model

The Panel has set out a range of criteria which would determine whether a propose-respond model and these need to be considered in light of the above assessment of market power and the consequences of underpricing versus overpricing:

In the Panel’s view the policy as distinct from legal arguments in favour of a propose-respond model depend on a number of propositions:

- *Truncated regulatory returns:* There is evidence of, or strong a priori reasons to believe, that conventional regulatory practices lead to artificially constrained (truncated) returns and hence under investment in socially important infrastructure. This applies most directly to new (greenfields) projects, but a history of under recovery of past investments in mature assets can influence investor expectations.
- *Asymmetric risk from regulatory error:* Even if there is no systemic bias in regulatory decisions, the costs of regulatory error are asymmetrical, i.e., errors leading to suppression of rates of return and under-provision of infrastructure are likely to outweigh the costs of errors leading to extraction of above normal rates of return from regulated infrastructure.
- *Systemic regulatory bias:* Regulators are prone to ‘self justification’ through setting prices that are popular with consumers which results in a systematic bias towards lower than justified regulated returns.

- *Regulatory uncertainty arising from methodology and data:* There is no unique methodology or universally accepted data set on which to base an estimate of the counterfactual 'normal' return that would be provided by a competitive market. In these circumstances the regulated entity's reasonable and defensible judgement (as the property owner) on an appropriate return is to be preferred to that of the regulator, with the regulator's role being restricted to identifying those (presumed limited) circumstances in which unreasonably high returns are likely to result.
- *Asymmetric knowledge:* Infrastructure owners are in the best position because of their knowledge base and intimate engagement with the industry to judge an appropriate return on investment and terms and conditions of access.
- *Reduced regulatory complexity:* Assessing proposals against broad estimates of ranges is an easier, less information demanding task for the regulator than setting an 'optimal' reference price and hence should be accomplished more quickly and at lower cost.

While these are the supporting arguments, for a propose-respond model to be demonstrated to be superior to conventional consider-decide regulatory approaches it must be shown to be both superior to alternative means of addressing these regulatory risks and capable of practical implementation. In the Panel's judgement neither of these requirements necessarily holds, and indeed each of the propositions is open to debate.³³

In light of the details discussed above UED now assesses the need for a propose-respond model for gas and electricity regulation on the basis of the above analysis.

Truncated returns

The above analysis clearly demonstrates that the costs of underpricing over the long term are substantially a more serious problem than overpricing and this would also be true for greenfield projects.

Asymmetric risk from regulatory error

The above analysis clearly demonstrates that the risks of underpricing over the long term are substantially a more serious risk than overpricing.

Systemic regulatory bias

This should not be necessary to prove given the risks of underpricing over the long term are substantially a risk then it should be a universal requirement to err on the side of the service provider.

Regulatory uncertainty arising from methodology and data

The Weighted Average Cost of Capital (WACC) has a number of variables that cannot be directly estimated from market data. Therefore the estimation involves the use of proxy data and various statistical estimation techniques. Under these circumstances the choice of the proxy data and the use of the various estimation techniques will produce ranges of estimates.

³³ Expert Panel, p. 68.

Where data is uncertain it is better to use ranges rather than point estimates as the distribution around the point estimate is unknown. The regulator is equally able to determine a range as a point estimate if the particular measure is unknown and subject to potential data assumptions and to estimation errors.

Asymmetric knowledge

It will always be the case that the business knows more than the regulator about the operations of its business. This is universally accepted but the regulator is required to make a decision on the business proposals and the ranges should be a key part of this assessment because of the uncertainty for five year forecasts and changes in economic variables over the regulatory period.

Reduced regulatory complexity

It is irrelevant if the regulator finds it more difficult to deal with ranges if this in fact best represents the operations of the forward looking regulatory regime. The West Australian regulator has dealt with the “ranges” issues in gas in a relatively seamless manner and there have been no appeals on these decisions.

The above assessments of the constrained market power of infrastructure services and the long term concern with under pricing means that the Propose - Respond is clearly a best practice model for energy industries.

Indeed the AEMC has recently advocated a propose – respond with ranges for capital and operations spending clearly indicating the problem with forecasting costs which has been used by the Productivity Commission to advocate propose respond with ranges:

The most recent propose-respond formulation is that suggested by the AEMC Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, which, in so far as it relates to pricing/revenue control, *inter alia*

- requires the AER ‘to accept a TNSP’s proposed forecast capital expenditure and operating expenditure where it is a reasonable estimate of its expenditure requirements having regard to a number of specified criteria’; and
- in relation to the AER’s final determination, requires it to accept a revised TNSP proposal if, *inter alia* ‘...forecast capital and operating expenditure are a reasonable estimate of the TNSP’s expenditure requirements’ having regard to a number of specified criteria.³⁴

The Panel also argues that the concerns do not justify the global acceptance of erring on the side of the regulated infrastructure owner;

While the Panel agrees that the potential for asymmetric consequences arising from regulatory error is an important consideration in regulatory decisions it has not been able to form a view that the consequences of regulatory error are necessarily asymmetric for mature infrastructure. Rather, the Panel notes that this matter requires an analysis of the benefits and costs from the perspective of society as a whole from increased or reduced investment (and the consequent elimination of transfers between different participants) and, in particular, to take account also of the resource costs

³⁴ Expert Panel, p.72

associated with inefficiently high levels of investment. Further, the Panel does not consider that, even if it was considered that regulatory error in a particular situation or generally would involve asymmetric consequences, systematically increasing returns across all regulatory decisions is not necessarily the most appropriate remedy. Rather, given the different forms of regulatory error that may be made, the appropriate response is to address the error as closely as possible to its source.

The Panel considers a more complete response to the potential for regulatory error (and the possibility of asymmetric consequences) is to ensure that the objective for the regulator is appropriate, the guidance is clear and that the mechanisms in place for review of the regulator's decisions are appropriate.³⁵

The above analysis clearly indicates that the long term problem is the risk of underpricing and that can best be alleviated by applying the Propose - Respond model and gas and electricity and adopting the regulatory ranges as an essential part of the regulatory model.³⁶

The Panel also comments on the issue of the rights for the regulated entity to make a submission:

The requirement under the Gas Code for a formal proposal from the regulated entity acknowledges the fact that much of the information which will form the basis of the regulator's decision must emanate from the business. A detailed submission from the regulated entity providing factual and forecast data, and interpreting the data in terms of the regulatory criteria, is an essential component of the regime. It ensures the regulator is fully informed, provides the basis for meaningful contributions to the regulatory process by other stakeholders, and provides the foundation for transparency and subsequent scrutiny of the process. In the Panel's view this should be a central feature of the AER's approach required under the AEMC's Electricity and Gas Rules respectively. There is no reason why these provisions could not be symmetrical between the sectors.³⁷

UED supports such an initiative and notes that the regulated entity should be able to make a price – service submission that sets out the customer services and service standards that is proposed for its customers and the price for those services. This should include any proposals for new services to encourage dynamic efficiency and to better service customers in addition to the option for price caps as outlined in Section 2 of this submission.

There is a further issue of regulatory simplicity and this goes to the Gas Code model where all regulatory details are contained in access arrangements. In comparison, there a vast range of electricity codes and guidelines that are unconnected because of the lack of an overall access framework and this does not provide a best practice regulatory regime. In light of electricity regulation being moved to an Access Arrangement basis the Panel should ensure that the advantages of such an approach are adopted.

The regulated entity should also be able to propose the basis of the WACC model as some states operate pre-tax WACCs while other states and the ACCC use post-tax WACCs. Changing from pre to post or vice versa may disadvantage a regulated entity or involve.

³⁵ Ibid, p. 71

³⁶ The ranges concept is also supported by the unknown variables in the WACC estimates.

³⁷ Ibid, p. 62

7 Components of Efficiency

The Panel outlines the three components of efficiency - allocative, productive and dynamic efficiency and makes the following points:

The Panel's view is that allocative efficiency is of no less importance as a matter for consideration by the AEMC in the development of Rules to be applied by the AER, although it notes that the relative significance of this form of efficiency remains an empirical issue. It therefore recommends that guidance be included in the NEL and the new NGL to require the Rules to provide incentives for the efficient use of existing and proposed new assets. It considers this approach to be more appropriate than the inclusion of specific guidance relating to price structures, since it allows the AEMC greater flexibility in considering a range of options to promote allocative efficiency.³⁸

UED notes that the Panel agrees that allocative efficiency is equally important in terms of investment and pricing but states that the AEMC should use greater flexibility in "considering a range of options to promote allocative efficiency". UED notes that given the long term requirement for the NEL and NGL objective reference should also be made to the AEMC using a range of options to promote both productive and dynamic efficiency as a priority. The Panel argue:

Allocative efficiency is improved when prices are set such that infrastructure is used efficiently. This generally means that prices should reflect the underlying costs of the provision of those services, thereby reducing the extraction of monopoly rents and maximising the use of those services and assets. It differs from productive efficiency, which focuses on minimising the cost of providing a good or service, and dynamic efficiency, which addresses concerns about ongoing investment in infrastructure, and ensuring that this investment is efficiently undertaken.

Allocative efficiency is contemplated in the current gas regime, by means of section 8.1(e), which requires reference tariffs to seek to achieve efficiency in the level and structure of tariffs.³⁹

It is odd that the Panel refers to Section 8.1 (e) as the Productivity Commission was critical of this clause arguing:

Section 8.1 provides less specific and operational guidance than the proposed national access regime pricing principles. For example, s 8.1 (e) of the Gas Code refers to efficiency in the level and structure of reference tariffs but does not state the specific methods that would be used to achieve this objective.⁴⁰

In any case the definition of efficiency needs to be considered in terms of the market in which it will operate. In this context the West Australian Supreme Court has established that the competitive market paradigm is a 'workably competitive market.' For example the West Australian Supreme Court stated that:

³⁸ Ibid, p.101

³⁹ Ibid, p. 101-102

⁴⁰ Productivity Commission, Review of the National Gas Regime, p. 260.

The expert evidence and writings tended in evidence suggest that a workably competitive market may well tolerate a degree of market power, even over a prolonged period.⁴¹

How should allocative efficiency be considered in such a workably competitive market? UED submits that allocative efficiency is less of an issue in such markets and that productive and dynamic efficiency may be more important.

UED supports the Panel's view of two part pricing and recommends its adoption in this form for the AEMC to implement:

The Panel notes that, in practice, such options may include the use of two part tariffs, the desirability of setting charges between incremental and standalone costs, and that tariffs take account of the circumstances of the customer classes to which they apply. Such arrangements should facilitate efficient forms of price discrimination, so that prices to different classes of customer may be adjusted downward (or upward) to reflect different demand circumstances, subject to revenue adequacy criteria and competition in upstream or downstream markets not being compromised.⁴²

8 Pricing Principles and the Framework for Decision- Making

Pricing Principles

The Panel recommends that the AEMC make pricing principles for gas and electricity are that:

- a) provide a reasonable opportunity for a network operator to recover the efficient costs of providing services that are the subject of the network pricing determination and complying with a regulatory obligation; and
- b) provide effective incentives to a network operator to promote economic efficiency in the provision by it of services that are the subject of a network pricing determination, including:
 - i. the making of efficient investments in the network owned, controlled or operated by it and used to provide services that are the subject of a network pricing determination;
 - ii. the efficient provision by it of services that are the subject of a network pricing determination; and
 - iii. the making of efficient use of existing assets and proposed new assets that are, or are to be, used to provide services that are the subject of a network pricing determination;

UED makes two points in regard to these pricing principles:

- Given the previous analysis indicates that the costs of under-compensation are greater than the costs of over – compensation the term “*at least*” should be added to read “*at least the efficient cost*”; and,

⁴¹ West Australian Supreme Court, WASCA 231, August 2002, Clause 128, p.60.

⁴² Expert Panel, p.101.

- Such a change would ensure that the pricing principles for gas and electricity are consistent with the new pricing principles in Part 3A of the Trade Practice Act which applies to other regulated infrastructure industries.

Pricing Principles and the Regulatory Framework

The Panel notes that the “responsibility of – and rationale for – the regulator is to bring impartiality, objectivity and transparency to the decision making process”.⁴³ The Panel again refers to the “properly impartial” regulator as a key consideration in the Panel’s assessment of the propose-respond model.⁴⁴

However the Panel seems to consider that procedural requirements alone will be enough to meet the requirements of impartiality, objectivity and transparency. In the table on page 22, the row titled “Decision making framework” deals only with procedural matters. So too the discussion in Chapter 5 focuses on process – the dot points on page 62, the topic at section 5.4.3 (Transparency and accountability requirements) and the proposal that the Rules require the AEMC to have regard to the regulated entity’s proposal, any relevant submissions made and any other relevant information and analysis to which the AER may have regard in accordance with the Rules.⁴⁵ Whilst it is desirable that the Rules bind the AER to consider these matters, they go no further than what procedural fairness requires in the general law. These matters also only address transparency, not objectivity of impartiality.

Of concern is the Panel’s related recommendation that the objective not be a matter to which the regulator must have regard as being of fundamental importance, as discussed above. So too is the Panel’s recommendation that section 16 of the NEL be repealed⁴⁶, section (1) of which deals with the manner of exercise of discretion.

This insufficient examination of the whole of the matters that go to an appropriate decision making framework is moreover a significant concern when coupled with the Panel’s recommendation that guidance to the Regulatory be a matter for the discretion of the AEMC.

The manner of decision making is as important as the objective to which it must have regard and the procedure underlying it. Impartiality must be addressed. The regulator should be required to exercise its discretion in a reasonable and substantively fair (as distinct from procedurally fair) manner. This should not be controversial. One only needs to regard the decisions of the Australian Competition Tribunal over recent years under the Gas law to see that such a requirement is warranted.

UED therefore considers that the term “*fair*” should be added to the above pricing principles to read “*provide a substantively fair and reasonable effort*”. This change should provide a better framework for regulatory decisions.

⁴³ Expert Panel p. 10

⁴⁴ Expert Panel p. 11

⁴⁵ Expert Panel p. 74

⁴⁶ Expert Panel p. 97

9 The Role for the objective

UED generally supports the Panel's recommendation on the objects clause. However, it is particularly concerned that the gas law formulation, with the identification of the long term interests of consumers as the core concept,⁴⁷ will entrench and justify the systematic bias which the Panel says must be avoided.⁴⁸

But UED queries why the explanation of efficiency as an economic concept is dealt with by the 'second best approach' of an explanation in the second reading speech and explanatory memorandum. Whilst it is common to look to extrinsic material to ascertain the purpose or object of an Act in order to promote a construction of a provision which is consistent with that object, even where there is no ambiguity, it is not mandatory to look at that extrinsic material.

Whilst as a practical matter it may be that a court will look at the second reading speech and explanatory memorandum, why would it not be better to insert the word "economic" before efficiency. This cannot be controversial and is clearly the first best approach. The second reading speech and explanatory memorandum can elaborate on the concept of economic efficiency but it should be the legislation which makes it clear that 'economic efficiency' is the goal, not any other concept of efficiency.

UED cannot support the recommendation that the NGL approach, of stating the objective broadly, is to be preferred. It is inconsistent with the Commonwealth's approach in the Trade Practices Amendment Bill 2006 which, in many provisions, requires a decision maker to have regard to the objects clause. In this the Commonwealth has adopted the recommendation of the Productivity Commission in its Review of the National Access Regime⁴⁹ which in turn accepted the submission from AusCid. The Commission said:

[the Commission] considers the objects clause should not simply be viewed as extrinsic material to be referred to only when the meaning of a constituent provision of Part IIIA is unclear. Rather, it should condition the interpretation of relevant provisions of Part IIIA...⁵⁰

This is of significant importance given the Panel's views that, "aside from the overriding objective, the direction to the AER should be given through the Rules without the AER having a direct accountability to give effect to high level principles in the Law".⁵¹ There should be no doubt that *the legislation* requires the AER to have regard to, as a matter of fundamental importance, the objective in that legislation.

⁴⁷ Energy Panel p.30

⁴⁸ Energy Panel p. 10

⁴⁹ Recommendation 6.2 at page 137

⁵⁰ Productivity Commission, op.cit. at page 136

⁵¹ Expert Panel p. 23

10 Information Gathering

The Intrusive Nature of the Panels Proposals

The Panel has recommended that the AER's statutory information gathering powers be modelled on section 28 of the NEL. This section provides for wider information gathering powers in comparison to section 41 of the Gas Pipeline Access Law. Section 28 of the NEL allows the AER to obtain information and documents in relation to performance and exercise of its functions and powers; this is significantly broader to section 41 of the existing Gas Law where the regulator's powers are connected with specific regulatory functions.

UED considers that the AER should only have information gathering powers associated with its specific regulatory functions, for example, powers should be limited to those required for the assessment of proposed access arrangements. This constraint would ensure that the AER does not go on 'fishing expeditions'. If nevertheless the information gathering powers endowed upon the AER were much broader, as in section 28 of the NEL, then these powers need to be appropriately constrained to prevent the risk of intrusive information gathering. Such intrusive information gathering can have substantial costs for regulated entities.

The Panel has disagreed that the concept of 'intrusiveness' of information requirements is helpful. UED considers the risk of the AER gathering information in excess to what is required for it to discharge its specific regulatory functions to not only be intrusive, but also inefficient. Forcing a business to conduct a time-consuming and costly process of information gathering on behalf of a regulatory body can be a highly inefficient allocation of limited resources. The potential of this occurring requires appropriate preventative measures.

The AER needs to be disciplined with a necessity test when gathering information and this should be reflected within the law and rules. The question to be asked by the AER is whether without the particular information, the AER would not be able to meet its regulatory function/s, and whether, the form of obtaining the information is the simplest and most efficient possible. If the AER's information gathering powers are too broad and non-specific, then regulatory risk is increased, as businesses will be forced to meet uncertain, unspecified and potentially large information requirements.

UED believes section 28 of the NEL which states that the AER can gather information and documents 'in relation to performance and exercise of its functions and powers', is too broad. UED considers it necessary to restrict the wording, for example, the AER can gather information and documents 'that are essential to its performance and exercise of its functions and powers in assessing and monitoring access pricing proposals'.

The Panel has recommended that the framework for information gathering powers should comprise statutory powers for the AER to obtain information that is relevant to the performance of its economic regulatory functions from any person. Similar to section 28 of the NEL, UED believes that information gathering 'relevant to the performance of its ...functions' is too broad. This proposal needs to be constrained to allow the AER to gather information only where it is essential to the performance of its functions.

The Issue of Contractors

The Panel proposes that contractors (not just related parties) will need to provide a broad level of information as described above. The Panel needs to recognise that the issues around third party and related party contracts is not simply one of information gathering for the purposes of addressing information asymmetry. At stake are the efficiencies that have been driven in the industry over many years through outsourcing arrangements and the nexus between private competitive markets and regulated markets. There is a need for a holistic examination of the contracting issue about which there is significant uncertainty arising from the recent price review in Victoria.

Just some examples of the complexity of this issue are:

- Does a business who has a service contract with a related party have the entire profits of that service contract removed on the basis of the contract not being appropriate where another business which is not trading with a related party is allowed to carry out the same function and recover a much higher cost than what was being claimed through the related party contract?
- Whilst the concept of inefficient contracts is recognised for related party contracts, it can also be the case for non-related party contracts. It is possible for companies to enter into a contract with a non-related party at an inflated price, in consideration of some other benefit through some other path. There is no prerequisite for inefficient contracts to be based on related parties. But what are the criteria for testing non-related party contracts? If it is size, is a contract for 100% of the services, 75%, 50 %? What if instead of one contract, there are three? The methodology ultimately adopted by the Essential Services Commission in the electricity price review in Victoria suggested *all* contracts, even those provided in a competitive market, should be examined for incentives⁵².
- Will this inevitable lead to regulatory rules prescribing just how contracts can and can't work? A lot of the efficiencies that have been achieved in the industry today have been on the back of an unfettered contracting regime. Once prescriptive rules are built around contracts, or worse, an environment of retrospective rule making is established, businesses will be greatly discouraged from efficient contracting, and may embark on retaining services in house.

Of particular concern to UED is the potential for serious consequences for the stability of the contractor market. Contractors will be required to set up accounting systems to the level of detail required which will involve substantial costs for a competitive sector. In addition, no contractor (or related party) will want to disclose their costs of doing business as it may be used to damage their competitive position. It will potentially provide other contractors with commercially sensitive information they can use to their advantage. The net public benefit of such an approach needs to be carefully considered.

The Panel proposal may have a number of unintended consequences. For example, if the costs rise for a contractor due to regulatory requirements and the contractor works in the competitive market and the regulated market, the contractor will not be able to pass the

⁵² Essential Services Commission Final Decision and Errata at section 5.2.5. See the flow diagram in the Errata.

costs on to the competitive market given its competitors do not have such costs and will seek to pass of the costs to the regulated sector. As a result of this regulated market costs will be higher than competitive costs. Will the regulator then consider that this is evidence of anti-competitive behaviour?

In addition, ownership matters. If a regulated entity has no ownership of the contractor then there is no need for intrusive information gathering powers to be applied in such cases.

There is also the danger of a duplication of costs due to related party transactions. Regulated entities reluctantly accept some duplication (i.e. corporations law reporting and regulatory reporting for AER) however these do not need to be further replicated to contractors/related parties. By forcing additional costs onto contractors the Panel is forcing the cost back to consumers or otherwise inappropriately intervening in a market that has operated effectively for a long period. To impose additional costs on entities that are not regulated and do not hold a licence is inappropriate.

UED considers that it is beyond the terms of reference for the Panel to consider issues arising from the current uncertainty around contracting in the energy sector created by the recent price review outcomes in Victoria. But the Panel should recognise these complexities and recommend that the issue of information gathering be deferred for consideration as part of a broader examination of contracting and the issues arising.

In addition UED notes that a “key theme in the Panel’s terms of reference is to advise upon measures that may reduce the cost of regulation, while maintaining its effectiveness”. The ardour of regulators to obtain what they consider to be necessary information may well have serious and lasting long term costs to the achievement of future efficiencies. In light of the Panel’s objective of reducing the costs of regulation UED proposes a different approach to the issue of contractors to be considered as part of a broader review.

New Policy Proposal

A more cost effective and efficient approach would be to allow contractors operating in the private sector (and where ownership was an issues) to benchmark their costs for the regulated entity against their private contract market. If the labour and capital costs per unit of output are similar there should be no concerns for the regulator.

Under this model contractors would be required to benchmark their operations annually in a report to the AER. Contractors that openly tendered for all work including work for the regulated entity would not need to provide a benchmark report. This model is based on the regulator checking whether there is anti-competitive behaviour by the regulated entity and minimising the costs of regulation to the contractors who work in competitive markets.