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Reflections from the Main Game: The Economic Regulation of Infrastructure

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Foreword by Mark Pearson, Deputy CEO Regulation, ACCC.

Ed Willett's term as a Commissioner of the ACCC and a Board member for the AER recently came to an end. Ed has had a diverse career working for both the Australian government and, for a short period, the New Zealand government. Taking the last twenty years – his work at the Industry Commission (IC) (including principal authorship of the IC's submissions to the Hilmer Review), his role from 1995 as the inaugural executive director of the National Competition Council (NCC), his appointment from 2003 as a Commissioner to the ACCC and concurrently, from 2005, to the AER Board – Ed is one of Australia's most experienced experts on competition policy and on economic regulation.

Given this, we were not going to let Ed retire from the ACCC/AER without capturing some of his insights. As Ed chaired the Utility Regulators Forum (URF), and as *Network* is the publication of the URF, a Lead Article for *Network* was an obvious choice. I commend Ed's fascinating article to *Network* readers.

Contents

Beginning in the 1980s, Australia embarked upon a major microeconomic reform program. While the aim was to increase productivity and competitiveness, and to open the Australian economy to international influences, these reforms did not tackle the infrastructure question. The key change in thinking that began to emerge was led in no small way by reports from the Industries Assistance Commission (IAC) (1989) and its successor body, the Industry Commission (IC) (for example, 1991a and 1991b). The Australian Government responded to the perceived lack of competition and lagging productivity by setting up a review committee, chaired by Professor Fred Hilmer. It reported in 1993 with the evocative title, *National Competition Policy* (**NCP Review**).

The NCP Review threw down the gauntlet in emphatic style with these opening words to the report:

> If Australia is to prosper as a nation, and maintain and improve living standards ... it has no choice but to improve productivity and international competitiveness of its institutions. Australian organisations ... must become more efficient, more innovative and more flexible. ... [T]here has been a growing recognition, not only in Australia but around the world, of the role that competition plays in meeting these challenges.

So the economy needed to be more efficient – more productive – and greater competition was required to drive that greater productivity.

The NCP Review was purposeful about the objective of NCP – it was all about efficiency. Following the advice of the Industry Commission (Submission 6, p. 5), the report categorised efficiency into three categories – 'technical or productive efficiency'; allocative efficiency and dynamic efficiency. This was probably the first time that the now-familiar trilogy of efficiencies was set out in this way. Productivity was an obsession of the time, and greater efficiency and greater productivity go hand-in-hand.

Government provision of infrastructure services at that time, usually with the protection of statutory

monopoly and unclear objectives, meant that pricing and investment decisions were often politicised, leading to cross-subsidies, inappropriate location of facilities and over-engineering.

The structure of institutions like 'Telecom', the urban water boards and the state electricity commissions was often inappropriate – regulation was combined with operations; monopoly parts were integrated with potentially more competitive parts; and horizontal integration often gave a poor focus to the individual aspects of the business.

The NCP Review recognised the importance of independent regulation – to separate it away from operations. It also recognised the importance of reorganising these operations into distinct business units with a clear commercial focus. And most importantly of all, it codified what needs to be regulated by drawing on natural monopoly characteristics to define 'essential facilities' that needed to be shared, by being subject to an access regime and separated out from potentially competitive activities.

By 1995, the reforms proposed by the NCP Review had become encapsulated as the National Competition Policy Reforms. Three intergovernmental agreements were signed on 11 April 1995 – Competition Principles Agreement, Conduct Code of Agreement and Agreement to Implement the National Competition Policy and Related Reforms. Clause 6 of the *Competition Principles Agreement* reflected an agreement to insert Part IIIA into the (then) *Trade Practices Act*. Clause 6, 'Access to services provided by means of significant infrastructure facilities', recognised that States and Territories might have their own effective access regimes. The newly created ACCC and the NCC had roles in applying this framework.

In contrast with the position adopted in many developed economies, where utility regulation developed on an industry-by-industry basis usually with a dedicated industry regulator that combined the functions of economic and technical regulation (for example, Ofcom, Ofgem and Ofwat in the United Kingdom), the NCP Review recommended (at pp. 248-9) that there be a common legal framework providing consistency in the approach to access issues across the economy. Inherent in this reasoning was a view that there were more synergies to be gained across the economic regulation of different utilities than across the economic and technical regulation of one utility.

The implementation of NCP and Part IIIA in particular was a remarkable achievement. The process which was followed to bring about NCP is now viewed as a model of how to successfully devise and implement major policy reform.

Building on Progress to Date

So, eighteen years down the road from the implementation of the NCP reforms and the introduction of Part IIIA into what is now the *Competition and Consumer Act 2010*, what has been learned about the performance of utility markets and regulation?

First, the strong focus on the importance of structural reform to promote competition by the Productivity Commission (PC) (and its predecessors) and the NCP Review appears, in retrospect, to have been appropriate, despite being contentious at the time.

Second, structural reform could never be the entire solution to the regulation of bottleneck infrastructure. Structurally separated natural monopolies, while posing less complex problems, retain the incentive and ability to deny or constrain access to the detriment of competition and efficiency. With its strong focus on the relevant economic problem, the Part IIIA provides a sound framework for the development of effective and efficient access regulation to be applied on a selective basis, and according to a common set of principles.

Third, many have suggested that Part IIIA processes, in particular declaration, have performed far less than perfectly. Whilst this may be true, to focus on the problems underestimates the challenges which are inherent in undertaking a reform as significant as that encompassed by Part IIIA and fails to take into account that the existence of Part IIIA has led to many commercial arrangements which were inconceivable before its introduction.

Fourth, Part IIIA has led to a significant change in attitudes towards the notion of access to bottleneck infrastructure. For the most part, the notion itself is no longer contentious.

Fifth, what remains contentious is the degree and extent of regulation necessary to promote access in the interests of competition and efficiency. Almost all of the regulation in place in relation to bottleneck infrastructure is regularly criticised. Whilst there is no doubt room for improvement, some of the trenchant criticism seems difficult to justify on an objective basis. Perhaps it reflects the fact that many issues are still under development and broadly based trust in regulatory processes and institutions takes time. [1]

Perhaps the differing interests of infrastructure owners and access seekers will always generate

[1] Readers will note the absence of any mention of public ownership in this list. While the benefits from privatisation of public entities was envisaged in NCP, it was not its focus. Nor is it the focus of this article.

intense debate, particularly given the nature of the infrastructure concerned.

Difficult problems are not easily solved. Australia's legal and regulatory system is one which has developed relatively quickly, but incrementally; the need for ongoing incremental reforms to Part IIIA plays an important part in addressing these issues. The current inquiry by the PC is an important part of that process.

1. The Importance of Structural Reform

As part of the NCP, a number of key structural reforms were implemented in electricity, gas and rail. In the National Electricity Market there was the separation of transmission, and ring-fencing of retail from distribution, leading to market driven structural separation. The National Gas Access Code mandated strong ring-fencing of pipelines. In rail, the Australian Rail Track Corporation was created to operate the interstate rail network and structural separation or ring fencing of below-rail infrastructure was put in place to varying degrees in all States.

The outstanding failure in this area of reform was the lack of any formal consideration of structural reform of Telstra prior to privatisation, in breach of the Federal Government's CPA commitments.

None of this is to suggest that vertical integration is never appropriate. The costs of separating particular supply-chain activities can overwhelm any benefits from functional level competition: a (non-infrastructure) example is the integration of steel-forming processes and the processes of shaping steel into a cooled product. The costs of trading in molten steel would outweigh any benefits from separating the forming process.

But in the context of infrastructure services likely to be the focus of Part IIIA, the claimed costs of separation have frequently been considerably less robust than this example, while the benefits to competition in dependent markets are often quite clear.

It is perhaps too easily forgotten now, but prior to the reforms to government-owned utilities of the nineties, including NCP, utilities by and large regulated themselves. NCP completed important moves to independent standards and economic regulation of utility services. There has been a related trend toward national regulation and regulatory institutions in relation to national utility services, for example in energy networks in the NEM, freight rail networks and water utility services in the Murray Darling Basin.

Structural separation of a bottleneck facility, absent any contractual relationships to the contrary, means that the facility owner has less incentive to discriminate between users of the essential input to the detriment of competition and efficiency. Structural separation does not guarantee the absence of anti-competitive discrimination (through, for example, exclusive dealing arrangements), but such discrimination is detected and countered more easily.

2. Structural Reform could never be the Entire Answer

Structural separation does not, however, address other issues of abuse of monopoly power by the bottleneck facility. Structural reform is an important complement, but not a substitute for access regulation. The NCP Review recognised that access regulation should not be confined to vertically integrated entities and arguments that it was implicitly so confined were rejected by the Australian Competition Tribunal (see, for example, *Sydney International Airport [2000] ACompT 1 (1 March 2000)*, paragraph 11).

Declaration and the attendant possible availability of mandatory arbitrated access terms has been widely considered to constitute highly interventionist (or 'heavy-handed') economic regulation (for example, see Productivity Commission, 2001). A legal obligation to supply certain services, by arbitration-imposed terms if necessary, is also widely seen as an imposition on the right to free enjoyment of infrastructure services by the infrastructure owner, that is, an imposition on property rights. Whether any such unfettered property right exists, even in principle, in modern economies is contentious in itself: many forms of regulation fetter the enjoyment of particular property rights; for example, land-use planning, building regulations, environmental regulation and the common law principle of nuisance.

Generally, competition law does not involve an obligation to supply: producers can sell to whomever they choose and on whatever terms they choose. This is an important general principle underpinning competitive markets.

But there have long been exceptions to this general principle. The US Essential Facilities Doctrine and Australia's Queensland Wire case are two examples. Both involve refusal to supply involving an anti-competitive use of market power.

Declaration focuses on a similar but more confined issue: where the potential refusal to supply is inherently likely to be anti-competitive because the relevant services constitute a bottleneck to competition in dependent markets. The importance of such services to competition in certain markets reflects two key characteristics of bottleneck services:

1. The facility that provides the relevant services has natural monopoly characteristics, meaning that one facility can meet the likely level of demand for the relevant services at substantially lower costs than if there were more than one facility in competition; and

2. That control of that facility can materially distort competitive conditions in related markets.

These two characteristics are reflected in the two key criteria for declaration in Part IIIA; Criteria (b) and (a) respectively.

The critical context for the obligation to supply is that it is imposed on only those facility services that meet very particular economic criteria variously, and sometimes loosely, referred to as 'bottleneck services', 'natural monopoly infrastructure services' and 'utility services'. Drawing on the US terminology, the NCP Review (p. 186) referred to them as 'essential facilities'.

Such key services have long been regarded as special in an economic policy sense. The US Essential Facilities Doctrine was first devised to deal with an attempt by a group of railroads controlling all railway bridges and switching yards in to and out of St. Louis to prevent competing railroad services from offering transportation to and through that destination. The Supreme Court of the United States held that the conduct amount to both an illegal restraint of trade and an attempt to monopolise (*United States v. Terminal Railroad Ass'n*, 224 U.S. 383 (1912) at 409-10).

In Australia, bottleneck services have either been publicly owned or developed by the private sector following some form of government concession or agreement. For example, the rail lines in the Pilbara were built pursuant to State Agreements between the relevant mining company and the State of Western Australia which granted the relevant rights to mine and develop the area but which also contained a form of access obligation. For example, the Mount Newman State Agreement (p. 7) contains an obligation to:

> …carry the freight of the State and of third parties on the railway… upon reasonable terms and at reasonable charges (having regard to the cost of the railway to the Company) PROVIDED THAT in relation to its use of the said railway the Company shall not be deemed to be a common carrier at common law or otherwise. [2]

Whilst provisions, such as those in the various Pilbara State Agreement Acts are different from the structure of current third-party access mechanisms, their existence reflects the fact that infrastructure with these key economic characteristics has long been recognised as requiring special obligations.

There is another consideration here that goes to the nature of bottleneck infrastructure regulation. Generally, the main concern about economic regulation is that it will, in some way, deter investment in relevant capacity. Regulating terms of supply of a firm with market power will dampen price signals that might encourage a new competitor.

But in the case of declaration, a new competitor to a service provider that met the criteria for declaration would, by definition, be inefficient. That is the important burden of Criterion (b), interpreted as requiring the existence of a natural monopoly or natural monopoly characteristics. Consequently, one of the key reasons for exercising caution in regulation (the risk of deterring new entry) needs to be considered knowing that any such entry is necessarily inefficient from the perspective of society as a whole.

Inefficient duplication of natural monopoly infrastructure can be profitable, at least in the medium term (PC, 2013, *Draft Report on the National Access Regime* (**PC Draft Report**), p. 157) and not all technical natural monopolies should be declared. In the case of relatively weak natural monopolies at given demand levels, it may be that small technical efficiency losses are outweighed by allocative and dynamic efficiency gains from competition. Cellular mobile networks may be an example of this. For this reason, the early Tribunal definitions of criterion (b) *(Sydney International Airport [2000] ACompT 1 (1 March 2000)*, Duke Eastern Gas Pipeline) might be preferable to the later, more technical interpretations. Then again, this difference in interpretation may matter little, since other declaration criteria, in particular the promotion–of-competition test and the public-interest test, are likely to address this issue. None of this provides an argument for a 'commercial viability' interpretation of criterion (b).

But it goes too far to suggest, as a general proposition, that 'duplication of infrastructure is not a rationale for access regulation per se, as duplication allows competition to develop and can constrain monopoly power' (PC Draft Report, p. 5). One of the key objectives of Part IIIA is efficient investment in infrastructure (s. 44AA), along with efficient use and operation. Investment in duplicative infrastructure which has such pervasive economies of scale as to be likely to swamp any allocative and dynamic efficiency gains from competition is likely to be, by definition, inefficient. Thus, any such general proposition as contended by the Productivity Commission is likely to run counter to sound Part IIIA objectives.

3. Not Perfect … but not bad either

In the two-stage process in declaration and arbitration, declaration recognises the infrastructure services that should be subject to an obligation to supply and applies an obligation to negotiate terms with access seekers. Arbitration provides a means to

[2] See also clause 2(a) of the Iron Ore (Robe River) Agreement entered into in 1964, which is in Schedule 1 to the *Iron Ore (Robe River) Agreement Act*, 1964; and *Hancock Prospecting Pty Ltd & Ors v- BHP Minerals Pty Ltd & Ors* [2003] WASCA 259.

resolve any dispute about the terms and conditions of access if the parties cannot reach agreement. It is important to recognise, as the PC does (Draft PC Report, p. 123), that the existence of the arbitration power will influence and condition the private negotiations. The economic literature examining this issue in the context of the labour market and discussed by the PC in Box 4.4 of its Draft Report is instructive.

The availability of an effective negotiate-arbitrate regime provides options for participants and potential participants in relevant markets and enhances incentives to invest in relevant activities. So, for example, the owner of a potential mining resource might invest to test the quality of the resource confident that a right to negotiate access to transport infrastructure will be available if the resource is proven. Without an effective negotiation right, the value of any investment in proving the resource would be vulnerable to capture by the infrastructure owner, and it is unlikely the investment would be made. Seeking to negotiate access prior to the investment would be difficult – the service provider would likely argue that the need for access was too speculative – and would risk incurring costs in relation to a worthless resource. So, the lack of an effective right to negotiate access would likely chill investment by resource owners who do not also own transport infrastructure.

The negotiate-arbitrate model constitutes the minimum level of regulation needed to ensure effective access to relevant services and in turn, ensure effective competition in dependent markets. This reflects the key insights of the NCP Review.

The Draft PC Report recommends (at pp.131-2) the retention of the negotiate-arbitrate framework as it accords primacy to negotiation, subject to an effective threat of arbitration. This is consistent with the underlying policy intent of the NCP Review and is less intrusive than other potential measures.

Criterion (b) was first interpreted as being a test focussed on natural monopoly characteristics by the Australia Competition Tribunal in *Sydney International Airport [2000] ACompT 1 (1 March 2000)* and followed in a number of cases with some refinement being provided in *Re Duke Eastern Gas Pipeline*. That was all turned on its head by the decisions of the High Court in *The Pilbara Infrastructure Pty Limited v Australian Competition Tribunal* [2012] HCA 36; and the Full Federal Court in *Pilbara Infrastructure Pty Ltd v Australian Competition Tribunal* [2011] FCAFC 58 (**Pilbara Infrastructure case**).

The High Court held at [77] that:

> The better view of criterion (b) is that it uses the word 'uneconomical' to mean 'unprofitable'. It does not use that word in some specialist sense that would be used by an economist. Further, criterion (b) is to be read as requiring the decision maker to be satisfied that there is not anyone for whom it would be profitable to develop another facility. It is not to be read as requiring the testing of an abstract hypothesis: if someone, anyone, were to develop another facility. When used in criterion (b) 'anyone' should be read as a wholly general reference that requires the decision maker to be satisfied that there is no one, whether in the market or able to enter the market for supplying the relevant service, who would find it economical (in the sense of profitable) to develop another facility to provide that service.

Its reasons for doing so were:

• The language used in the provision must drive its interpretation rather than the use of extrinsic material.

• A test which focuses on questions of inefficiency (natural monopoly) is inherently asking an abstract question and does not ask questions about actual likely market behaviour. That deprives the words 'for anyone to develop another facility' of much meaning, when it is a standard principle of statutory interpretation that an interpretation which gives full meaning to all of the words used is preferable. The private profitability test does not suffer from that problem;

• In order for Criterion (b) to be satisfied, the conditions for natural monopoly must be met throughout the period of declaration and demand and cost considerations over that time frame are very difficult to predict and changes in technology can often not be predicted at all.

• If there is a credible threat of entry, even if such entry is inefficient, that threat of entry is likely to constrain the behaviour of the incumbent.

• There are circumstances in which it would be appropriate for access regulation to apply to infrastructure which is *not* a natural monopoly. The High Court considered access to be appropriate in circumstances where construction of an alternative facility is not profitable even if that facility is not a natural monopoly. Not to provide for access in that situation 'with the attendant risks of abuse of market power and, no less importantly, with no incentive to price and produce efficiently does not sit easily with the requirement that criterion (b) be understood in a way that will 'promote the economically efficient operation of, use of and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets'.

The High Court therefore recognised that a test of private profitability is likely to apply to infrastructure which would not be caught by the natural monopoly test. It is therefore curious that some argue that a private profitability test is a narrower test than a test which focuses on characteristics of natural monopoly.

With this interpretation of Criterion (b), one can see some of the types of facilities (for example, sports stadiums and ski lifts) which have been found to meet the US essential facilities test meeting Criterion (b) on this approach. There will, however, be a question whether these facilities will meet Criterion (a).

The Draft PC Report has, however, recommended that Criterion (b) be amended so that it is satisfied where total market demand could be met at least cost by the facility at issue – that is, a technical test of natural monopoly reflected in more recent Tribunal decisions. The PC considered this test to be better suited to capturing facilities where there could be an enduring lack of effective competition in the provision of infrastructure access, and decreases the risk of false positives, in comparison with a test of private profitability.

The recommendations of the Draft PC Report conform much more closely to the thinking of those who were involved in the development of the key principles underpinning the introduction of Part IIIA, and National Competition Policy more generally, than does the result in the High Court's decision in the Pilbara Infrastructure case. As discussed above, the best formulation of the thinking underlying Criterion (b) was that expressed by the Tribunal in the Duke case (rather than the technical test of more recent Tribunal decisions). That was actually a different formulation from that proposed by Professor Gans (2007) to the Tribunal in the Pilbara matters and described later as the 'net social benefit test'.

Declaration has been imposed once in relation to Melbourne Airport, twice in relation to Sydney Airport, once in relation to wastewater services provided by Sydney Water, and in response to the Tasmanian government's application for declaration of rail infrastructure in Tasmania. There have been two applications for arbitration to the ACCC, only one of which proceeded to a determination, and that was a determination on the pricing methodology which would be appropriate (ACCC, 2007). Consequently, some suggest that declaration has proven so cumbersome and little used that it is not worth the fuss and trouble. This view adopts too narrow an interpretation of the intended role and impact of declaration.

First, declaration is a fall-back for services where declaration might be appropriate but where the relevant services are not subject to an industry-specific access regime. The relation between declaration and such regimes is discussed in the next section.

Second, the view that declaration is unnecessary focuses too much on the regulatory outcomes, that is the number of successful declaration applications and the number of completed arbitrations, and too little on the economic outcomes of the availability of declaration.

In *Sydney International Airport [2000] ACompT 1 (1 March 2000)* (paragraph 20) the Tribunal sought to identify the purpose of declaration and was entirely accurate:

> The declaration of a service pursuant to s 44H of the Act is akin to unlocking the door, but whether or not a particular party can then go through the door depends on the party's ability to negotiate an access agreement with the provider or, in default of an agreement, to have an arbitrated outcome of that situation.

In other words, declaration is not about access or the degree of access likely to be granted, but about providing a realistic opportunity (that is, an opportunity that is more substantial than a mere opportunity to be told: 'no, go away') to negotiate access. As a result conditions the environment for access negotiations by addressing the market power of the service provider.

It is the opportunity to gain access that empowers a potential market entrant with the means to compete; to make a commitment to a market and thereby changing that market and making it more contestable and competitive.

The alternatives to a negotiate-arbitrate model include upfront regulatory arrangements such as: those which are used in the telecommunications access regime; for electricity transmission and distribution services; and for wheat export facilities at ports. While sometimes useful and often regarded as an alternative to access regulation, various forms of mandatory information disclosure generally involve no obligation to supply, so fall short of the minimum level of regulation required to ensure access.

Given the nature of the role which declaration plays in the current combination of industry-specific and general regimes, there does not seem to be a case for more intrusive arrangements.

Generally speaking more detailed industry-specific regulation may be appropriate where the transactions costs of negotiation are likely to be relatively high, while the benefits of flexible negotiated outcomes are likely to be relatively low. This might occur where:

- there are many access seekers;
- there is strong homogeneity in access services;
- the cost of access services are a relatively small proportion of the value of the end product; and
- there is a history of, or otherwise a strong case for, common-carriage arrangements.

The nature of third-party access rights provided for under Part IIIA are different, in important respects, from more general infrastructure sharing or common

use. This stems from the concerns expressed in the NCP Review about protecting the legitimate needs and interests of the infrastructure owner (p. 256):

> With privately-owned facilities, in particular, it would be appropriate to ensure that an obligation to provide access does not unduly impede an owner's right to use its own facility, including any planned expansion of utilisation or capacity. It may be appropriate to require that access be provided on a 'non-discriminatory' basis, although what this is intended to mean in a particular setting should be spelt out. For example, it may be appropriate for the owner of a private facility to give priority to its own requirements in determining access to the facility in some circumstances. Similarly, discrimination between different third-party users should not be prohibited where the discrimination relates to objective efficiency-related considerations, including different costs associated with providing access to different users.

These comments were reflected in three important characteristics in Part IIIA that go to what access rights should be available to access seekers:

• The distinction between third-party access and common carriage.

• The degree of capacity available: the role of the notion of spare and developable capacity.

• The extent of allowable discrimination between access seekers and the access provider.

Declaration has been established on a third-party access basis. The key characteristics of third-party access are:

• Access is available to 'spare and developable' capacity; that is capacity that is currently available, or that which can reasonably be developed, over and above that capacity that might reasonably be required by the infrastructure owner, and/or which is already committed by existing contracts.

• Access prices should reflect all the costs of providing access, including a reasonable return on the infrastructure owner's costs and the additional costs to the access owner of providing access, such as the costs of access systems and access negotiations.

• A non-discriminatory principle may be applied, such as a prohibition on anti-competitive discrimination between access seekers, but this principle would be subject to the preference to the capacity needs of the owner and/or existing users.

• There is no obligation to compensate the infrastructure owner for any loss of monopoly profits in dependent markets as a consequence of access.

Common carriage involves no preference to existing users. Under common-carriage arrangements, there is usually no discrimination between users and capacity is allocated by some form of queuing arrangement or market mechanism, such as an auction. Common carriage access is more likely to support effective competition in dependent markets, largely because access is on a more equal basis. Common carriage arrangements generally require some form of legislation, access code or detailed undertaking.

Third-party access is a less intrusive form of access regulation and may be more suited to some circumstances, such as bulk community export arrangements where access seekers are likely to be few and natural production advantages already mean differential returns to producers.

Examples of industry-specific access regimes that are on a common-carriage basis include: electricity networks under the NEL; distribution gas pipelines under the NGL; rail access under ARTC undertakings; and access provisions for the NBN. Industry-specific regimes based on a third-party access approach include transmission gas pipelines under the NGL. In addition, telecommunications access under Part XIC of the Act was also originally designed as a third-party access regime, but over time, it has taken on more and more of the characteristics of a common-carriage arrangement.

The notion of spare and developable capacity is critical to third-party access regimes. It is trite to recognise that if the owner and existing users has some form of priority, then access to 'third parties' is only available to the extent that there is spare capacity remaining. But the notion of developable capacity introduces a more complex and contentious set of issues. Under Section 44W(1) of the Act:

> The Commission must not make a determination that would have any of the following effects:
>
> … (e) requiring the provider to bear some or all of the costs of extending the facility or maintaining extensions of the facility;

Implicit in this provision is that the Commission can require the provider to 'extend' the facility if the provider is not required to bear any of the costs; presumably, those costs should be borne by the access seeker. Three questions of interest arise here: What does 'extend' mean in this context? What does 'bear some or all of the costs' mean? What happens if more than one access seeker wants the facility extended? Or if other access seekers benefit from the extension whether at the same time or later?

As discussed in the PC's Draft Report (p.134), although Part IIIA refers only to 'extend', the Tribunal has identified that in addition to geographical extensions of a facility, the term also encompasses the expansion of a facility's capacity (paragraph 722–3). Incorporating an expansion power assists in ensuring service providers do not undermine the efficiency objective of Part IIIA. Making this power

explicit, as recommended by the Productivity Commission, would be of significant assistance.

One interpretation of the phrase 'bear some or all the costs' is that an access seeker would need to meet all the costs directly of expanding capacity, and that at no time would the provider meet any costs, even if later reimbursed. This is a rather strict interpretation which:

• jars with the approach to provider cost recovery in other contexts; for example, the additional negotiation and systems costs incurred by the provider would normally be recovered in ongoing access charges; and

• raises some practical difficulties; for example, how would access fees take into account that an access seeker has paid for part of a facility but has no interest in it (s. 44W(1)(d)).

This approach is consistent with the advice which the NCC has received from the Australian Government Solicitor to the effect that the requirement prevents the ACCC requiring a service provider 'to pay for an extension in whole or in part, regardless of its value to a service provider' (NCC, 2008, 9.185).

However, it would be preferable in seeking to achieve the objectives of Part IIIA for the access seeker to have the opportunity to meet all of the costs of the expansion through ongoing access fees. Some surety may be required, such as a guarantee and a long term 'take or pay' contract covering the full cost recovery period.

Providing for this approach, at a minimum, might also support a better environment for negotiation and agreement on particular terms. First, it would provide access seekers more assurance that they would not find themselves paying for access twice: by paying all the expansion costs without getting any interest in the facility and then paying access fees based on the increased value of the expanded facility. Second, it would reduce the risk that the access seeker who pays for the expansion then faces competition from later access seekers who are able to gain access to the expanded facility on more favourable terms.

The narrow interpretation of s. 44W(1) is particularly awkward where an access seeker pays for capacity expansion, but does not use all of the capacity made available. What terms should then be available to a new access seeker or the provider who wants to utilise that spare capacity? The provider has already been fully compensated for the expansion, so any fees would constitute excess compensation.

However, on the more liberal interpretation, a long-term contract with the first access seeker as outlined above could accommodate this development. The contract could specify that the first access seeker could be rebated access fees if any of the new capacity were allocated to a subsequent access seeker. As discussed in the PC Draft Report (p. 139) these types of provisions are not unusual in long-term gas transportation agreements which underpin development or expansions of natural gas pipelines.

Non-discrimination provisions of some form are common in Part IIIA arrangements. But what does non-discrimination mean: what forms of discrimination are prohibited by this?

On one view, non-discrimination means that all access seekers are offered the same terms and any negotiation of different terms is prohibited. In other words, the first access seeker effectively determines the terms of access for all who come later.

This interpretation is too strict, impractical and likely to lead to inefficient outcomes. Negotiation of differing terms can be beneficial, being specially designed to meet an access seeker's needs. Only anti-competitive discrimination is likely to raise concerns, for example, where particular access terms are not available to all access seekers in similar circumstances.

4. Changing Attitudes toward Access

In retrospect, one of the major contributions of the National Access Regime is the development of changed attitudes toward access. Underutilised infrastructure is not to Australia's economic advantage and the principle-based approach to access provided by Part IIIA of the Act allows existing infrastructure to be shared, with the consequent advantages of increased investment in related activities.

There were a number of particular developments over the past two decades that have made a contribution toward changing attitudes on access:

• The increased reliability afforded by a more integrated gas pipeline grid as exemplified by the Longford supply interruption in Victoria and the saving role of the newly developed Interconnect.

• Recognition of the advantages of sharing electricity generation across state boundaries in the National Electricity Market.

• Growing awareness that the totally integrated supply chains of the Pilbara iron ore incumbents would not support a wider range of mining interests: each miner building its own infrastructure did not make sense.

• Recognition that inadequate access arrangements for Telstra fixed-line services, in the context of vertical integration, cramped network upgrade.

• The development of a national rail network, in particular through the role of the structurally

separated and open-access Australian Rail Track Corporation.

• Recognition of the costs of regulation that lacks an appropriate balance between the interests of service providers, users and consumers in the NEM as discussed further below.

Consequently, there is greater acceptance of the notion of access to bottleneck infrastructure in business and the community that was the case twenty years ago.

5. Building Trust in Regulation

Regulation of natural monopoly bottleneck infrastructure came relatively late to Australia, in large part as consequence of its history of widespread delivery of these services by vertically integrated public monopolies. In particular, Australia's lacks the US's long history of a form of essential facilities doctrine as part of its general antitrust law. Any such regulation is inevitably intrusive on infrastructure owners' interests, and thereby highly contentious. The rapid and comprehensive implementation of access regulation in Australia under NCP has amplified this contention.

Most commonly, concern about access regulation has been expressed in terms of likely adverse implications for future investment. [PC 2002 Part IIIA review among others] While the implication for investment in regulated infrastructure is important, they are no more important than other components of the long-term interests of consumers and the community, such as investment in dependent markets and end-product prices and quality.

Greater concern about investment in regulated infrastructure has been justified on the grounds that such investment is better than no investment. This argument adopts an 'all or nothing' approach to investment incentives that is rarely, if ever, realistic. Excessive investment in, and inefficient use of, infrastructure is generally a question of degree, and is costly to the community. The same applies to investment in dependent markets. All are key components of the interests of consumers and the community, and infrastructure regulation needs to strike an appropriate balance in these considerations.

The skewing of infrastructure regulation toward the interests of infrastructure owners and investment in infrastructure has damaged the development of Part IIIA as an effective access regime. There is no better example than the recent experience in electricity network regulation. Amendments to the electricity law and rules around 2005 and 2006 in an environment of concern about infrastructure investment biased the regulation in favour of investor interests and investment. Consequently, electricity prices escalated to a politically unsustainable level, especially in the states where networks remained in public ownership. Network needs and the upheaval of the GFC justified some price increases. But the level of price increases realised was well beyond what could have been, or in a more balanced regulatory regime would have been, justified.

The electricity experience of recent years has caused damage not just to the standing of the NEM – which otherwise makes a strong case as the best electricity market in the world. It has damaged the standing of NCP and sound infrastructure reform principles more broadly. Whereas it should be possible to point to the NEM as a successful, world-leading reform, any comments now must be heavily qualified. In the meantime, political support for further infrastructure reforms, such as deregulation of electricity retail markets and privatisation, has waned.

However, it may be that the electricity experience provides a salutatory and enduring lesson. Strong, broadly based community support for the AER's proposed rule changes, and other refinements to restore an appropriate balance in NEM regulatory arrangements, was a direct consequence of recognition that the previous arrangements were inappropriately skewed in favour of service providers. There appears to be a strong consensus that balanced, independent national regulation of the NEM is needed, particularly compared to any move back to increased political intervention in oversight arrangements. There appears to be an improving environment among all parties, recognising that it is in the interests of all participants to ensure that regulation under the amended rules works well.

This has coincided with other developments that suggest that access policy in Australia is approaching an important transition point.

There has been a recent shift in thinking about the objects of infrastructure reform. The focus on investment has been replaced by a more sophisticated view that recognises that new investment needs to be efficient (that is, furthering the interests of the whole community) and that there is also need to make better use of existing and new infrastructure. This reflects the objectives of Part IIIA. It involves, first and foremost, well-designed infrastructure pricing to maximise the value of infrastructure to the community, including by well-designed access pricing for bottleneck infrastructure. It also involves new thinking about the appropriate role of government in infrastructure provision: first to free up scarce public resources in existing infrastructure, and second, to recognise the commercial challenges facing investment in long-life, natural monopoly infrastructure (Infrastructure Australia, 2013, p. 17). Thus, there is renewed recognition of the special role of natural monopoly infrastructure that echoes historical thinking in the US and Australia, albeit with different solutions over time.

Commercial investment in natural monopoly infrastructure often faces a conundrum: since by definition, costs per unit output fall with utilisation of the infrastructure, the commercial viability of the infrastructure may turn on attaining full utilisation – that is by establishing itself as a monopoly. Pricing based on full utilisation may be needed to attain full utilisation, since pricing based on a lesser level of use will need to be higher, and thus is likely to deter efficient use, and so on. This potential vicious circle is exacerbated if any risk of under-utilisation needs to be compensated by a higher return, and if, as is often the case, the commercial timeframe for assessing the investment is less that the life of the investment.

The pro-investment view of natural monopoly infrastructure discussed above has generally considered that the solution to this problem is to avoid any truncation of returns over the life of the investment to maximise the opportunity to offset lower early returns. An alternative approach was reflected in the ACCC's Greenfield Pipeline Access Guidelines (2002) and, at least partially, pricing arrangements for the NBN. This approach allowed a greenfields infrastructure investor to price at full utilisation levels in the early days to encourage take-up, and then 'roll forward' any losses to be recovered in later years. The difference in the approaches is that the latter restricted high later returns to a level that recovered risk-adjusted early losses and no more. Another approach, where such utilisation risk undermines the commercial viability of natural monopoly infrastructure that nonetheless satisfies a public interest test, is for the public sector to underwrite the utilisation risk. There is an element of this in the funding of the NBN. It is also similar to the way that new investment in electricity networks is recovered from a broad segment of electricity users rather than direct beneficiaries. [3] Government roles and/or cross-network approaches in underwriting utilisation risks diminish arguments for access holidays for new infrastructure and support a view that balanced access regulation for such projects is appropriate, where the standard coverage tests are satisfied.

In the meantime, contention about access regulation has diminished for other reasons. After eighteen years there remains a lack of evidence to support the early dire predictions of private gas pipelines, communications, airport, railway and other infrastructure interests about the damaging effects of access regulation. Meanwhile, community concerns about monopoly behaviour in these sectors have tended to increase. Gas transmission pipelines and the major airports provide interesting case studies of the role of Part IIIA, and declaration/coverage in particular. These facilities are largely uncovered, but declaration/coverage has been applied in the past and generally remains available. Undoubtedly, this has conditioned the conduct of these facilities to at least some extent. Nonetheless, examples of creeping monopoly conduct by such facilities emerge from time to time.

This has prompted arguments that, one way or another, coverage/declaration of such facilities should be the default model, with consequent better and more timely access to dispute resolution, but only if required by a breakdown in negotiations. The argument is that this would provide a more effective constraint on service providers, even if actual arbitrations remained rare. In a more mature environment for access regulation, is this an appropriate step? The answer probably turns on credible demonstration that arbitration will be available sparingly, and the onus will be on the parties to make genuine efforts to resolve disputes commercially. The limited experience with arbitrations to date tends to suggest that this might turn out to be the case.

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[3] Note that any network-wide underwriting of investment risk should ensure that all pricing covers at least incremental cost. But also note that in natural monopoly network infrastructure, incremental cost tends to be low compared to stand-alone cost, increasing the scope for cross-network underwriting of investment risk. Such risk underwriting may also help solve specific project risk issues that arise where funding is arranged on a point-to-point basis, rather than a network basis, as commonly occurs in road projects.

Critical Issues in Regulation – From the Journals

'Mobility Barriers and Market Power – Determining the Extent of Entry or Expansion under Australian Law', Ben Morawetz, *Competition and Consumer Law Journal*, 20(3), April 2013, pp. 199-212.

Ben Morawetz analyses strategic-group theory and examines the economics of mobility barriers. He finds that mobility barriers are an important economic tool to assist courts in undertaking market power analysis.

Mobility barriers are a source of market power. While they are analogous to barriers preventing entry into an industry, mobility barriers operate between subgroups of firms ('strategic groups') within an industry. In their 1977 QJE paper, Caves and Porter propose that an industry may comprise of strategic groups, where firms within a strategic group pursue similar strategies to maximise profit. Different strategies exist in different strategic groups, and barriers may exist between the strategic groups. For example, it may be difficult for a firm to enter a strategic group consisting of nationally advertised brand-name producers. It may be less difficult to enter a strategic group of regional, private-label producers even when the goods are otherwise identical across strategic groups in the industry.

Morawetz examines the extent to which Australian courts have considered barriers to mobility in the context of the misuse of market power provisions of the Competition and Consumer Act 2010. Key cases are analysed. These include the 'Safeway Case' (ACCC v Australian Safeway Stores Australia Pty Ltd (2001) 129 FCR 339) and the 'Universal Music Case' (Universal Music Australia Pty Ltd v ACCC (2003) 131 FCR 529).

The importance of barriers to expansion was raised in the 'Ticketek Case' (ACCC v Ticketek Pty Ltd [2011] FCA 1489). The alleged conduct related to refusal by Ticketek to implement certain discount prices when requested to do so by promoters or venue operators. The ACCC alleged, and Ticketek admitted, that it had a substantial degree of power in the relevant market. As noted by Morawetz, Ticketek made this admission 'because there were barriers to potential or existing suppliers expanding into a business capable of providing the kind of full service offering that might have constrained the major players'.

The Federal Court of Australia, by consent, imposed penalties of $2.5 million upon Ticketek, made declarations that Ticketek had contravened the Competition and Consumer Act 2010 and ordered Ticketek to pay $100 000 in costs.

In summary: entry barriers allow firms to ignore potential competitive pressures from firms outside the market. Mobility barriers allow firms in one strategic group to disregard competitive pressures from firms in other, inferior strategic groups within the industry. Studies suggest that high mobility barriers may allow firms within a strategic group to earn supra-competitive profits. Morawetz emphasises that an assessment of mobility barriers and strategic groups is a useful starting point for courts to identify the presence of market power. However, each case must be examined on its merits to determine the levels of constraint imposed on an incumbent by: firms in the same strategic group; firms in other strategic groups; and firms not operating in the industry.

'Why Johnny Can't Regulate: The Case of Natural Monopoly', Henry Ergas, *Agenda* 20(1), 2013, pp. 43-54.

In this paper, Henry Ergas raises the question of whether utility regulation is doomed to end in failure. Will Johnny, who wants to grow up to be a regulator, end up with nothing but disappointment?

The author raises the question of what regulation is designed to achieve, observing that, due to transactions costs, a Coasean bargain contract between the customers and the supplier would be subject to the risk of ex post opportunism – both on the side of the supplier (who might threaten to raise the price ex post) and on the side of the customers (who might seek to expropriate the sunk investment of the supplier by collectively agreeing to lower the price). Given these risks, either side may fail to make valuable sunk investments, or, as Ergas puts it, either side may make investments which are inefficient due to the threat of opportunism: 'each side would invest in costly precautions so as to ward them off. But ... those investments, seen from a societal perspective, are merely a waste, reducing welfare'.

Ergas proceeds by asking whether the government can directly step in to recreate the Coasean bargain on behalf of small customers. He points out many problems, including those relating to the aggregation of consumer preferences, time inconsistency, opportunism and difficulties with monitoring and enforcement.

Ergas asks whether these problems can be resolved by delegating certain powers to an independent authority. Perhaps such delegation allows for information collection, perhaps an independent authority is easier to monitor, or perhaps it can resolve the commitment problems. The example of an independent central bank is often used to show

how the time-inconsistency problem can be resolved by delegation to an independent authority. But Ergas goes to some lengths to distinguish the role of a central bank from the role of an independent regulator. An economic regulator is likely to have a much wider range of instruments at its disposal and more vaguely-specified objectives. Moreover, the incentives for time-inconsistency are stronger for a regulator than for a central bank. He also suggests that newly-established central banks seek to invest in a reputation for being tough on inflation.

Finally, Ergas expresses concerns that regulatory decisions are affected by the wider political context, citing as examples changes to the merits review process in electricity and ministerial powers of discretion in relation to the NBN. He concludes that: 'In short, regulation is no magic wand that can, at no or low cost, replicate the outcomes of the idealised Coasean bargain. Moreover, conventional nostrums for the conundrums it raises – most obviously, the 'solution' of delegating powers to an independent regulator – create many problems of their own. To those problems there are no simple solutions, and most of the attempted solutions have yielded very mixed results'.

'Estimating the Marginal Cost of Quality Improvements: The Case of the UK Electricity Distribution Companies', Tooraj Jamasb, Luis Orea and Michael Pollitt, *Energy Economics*, 34, 2012, pp. 1498-1506.

Economic regulators of energy networks have designed various quality-incorporated incentive-regulation models. For example, in Norway, quality incentives are integrated into the cost-benchmarking methods that are used in determining the allowed revenues of energy businesses. In the UK, the Ofgem has adopted quality-of-service targets with an associated penalty-and-reward scheme for energy networks. In both regulatory practice and the academic literature, the focus has been on quantifying consumers' willingness to pay for quality of service. Alternatively, the marginal cost of quality improvement can be estimated to establish a lower bound for incentive targets.

This paper develops an econometric approach to the estimation of marginal costs of improving quality of services in electricity distribution, and assesses the effectiveness of the current UK incentives to improve quality.

Using UK electricity distribution data for the period from 1995 to 2003, the authors estimate a cost function modelling the relationship between total expenditure (that is, the sum of operational and capital expenditure) and cost drivers that capture network length, network density, energy losses, quality of services (for example, customer minutes lost), time trend and weather conditions. Based on both theoretical grounds and empirical testing, the authors consider that changes in the quality of service depend mainly on past expenditure rather than on contemporaneous expenditure. The estimated relationship between the cost and the expected level of service quality gives a measure of the marginal cost of quality improvement.

The results show that the marginal cost of improving quality varies across networks on account of the different configurations. In general, however, the marginal costs estimated are much larger than the incentives offered by the Ofgem. This suggests that the regulatory incentive to reduce service interruptions has not been strong enough to achieve the economically efficient level of service quality. However, the incentives to encourage utilities to reduce network energy losses have led to performance improvement. The authors consider that the observed improvements in quality during the sample period only represented about 20 per cent of the potential consumer welfare gains, leaving considerable scope for further improvements in service quality that will be welfare-enhancing.

'Access Regulation, Entry and Investments in Telecommunications', Fabio Manenti and Antonio Sciala, *Telecommunications Policy*, 37, 6, July/August 2013, pp. 450-468.

In this paper, the authors present a theoretical model aimed at better understanding the conditions for welfare-enhancing investments in the market for advanced communications services. In this model, an incumbent and an entrant compete in the market; and the entrant has to decide whether to enter as an 'infrastructured entrant' or whether it buys access. There is a 'welfare-maximising regulator'. The stated aim of the paper is to determine the impact of access regulation on the type of entry and on the amount of investment in advanced communications services. Two types of access are considered – one-way interconnection and bilateral access.

In the absence of access regulation, the incumbent will set a sufficiently high access price that entry will be foreclosed. In this circumstance, if an entrant wanted to participate in the market it would have to provide its own infrastructure. Such entry may not be efficient. Further, in some circumstances ('in a large subset of the parameters' space') where entry is deterred, this is also inefficient.

The main section of the paper, headed 'The model', is a highly technical exposition of the analytical framework used. The authors remark that the analysis is consistent with the familiar 'ladder of investment' hypothesis (p. 453) that has been prominent in the literature on access regulation over the previous decade. Sub-sections in order are titled:

'facilities based competition'; 'regulated access'; 'regulation without commitment'; and 'regulation with commitment'. Some key terms, in approximate order of appearance, are: 'upstream'; 'ladder of investment'; 'QoS'; 'spillover'; 'consumers' surplus'; 'producers' surplus'; 'inefficiency'; 'entry game'; 'credible commitment'; 'Nash bargaining'; and 'Cournot'. The bulk of the paper is about one-way access (an incumbent providing access to an entrant), but the authors also consider 'bilateral access' or 'reciprocal interconnection'.

One key result of the analysis is that there is a difference between the impact of ex post and ex ante regulation of one-way access. In the case of ex post regulation, after firms have made their investments, 'regulatory failures' can occur. In the case of ex ante regulation, 'failures can be reduced but not eliminated'. More generally, the authors conclude as follows (p. 465):

It is not desirable to have access regulation unless the regulator is able to credibly commit to a predetermined regulatory policy.

Having considered one-way access, the authors then turn to consider bilateral access (pp. 462-464). Their analysis suggests that 'inefficient infrastructure entry tends to be more likely … in this case … [and] access regulation appears to be less detrimental' (p. 465).

The authors identify a number of 'limitations' of their analysis. The most important of these is the absence of a consideration of either co-investment (sharing the cost of deploying infrastructure) or risk-sharing. They refer to a paper by Cambini and Silvestri for an analysis of the implications for co-investment for access regulation.

While the paper is both theoretical and technical, the authors do provide some guidance for non-expert readers: the introduction and the conclusion are non-technical; and explanatory passages usually follow mathematical equations. Further, some quite familiar ideas, such as the 'ladder of investment' and 'Cournot competition', are inherent in the analysis. These features enhance readability.

'An Empirical Investigation of the Determinants of Asymmetric Pricing', Marc Remer, EAG Discussion Paper 12-10, US Department of Justice, Antitrust Division, November 2012.

In this paper, 'asymmetric pricing' refers to a situation in which retail prices respond faster to cost increases than cost decreases. The paper identifies the existence of asymmetric pricing at the retail level for regular unleaded fuel and for premium fuel in response to changes in daily gasoline spot prices on the New York Mercantile Exchange. The dataset comprises one year of daily firm-level price observations for over 11 000 gas stations. The large dataset allows the use of a variety of controls, including firm-level fixed effects, measures of spatial competition and independent competition and day-of-the-week effects. Relying on relatively standard methods, the paper finds that five days after an initial change to the spot price of gas, firms incorporate 46 per cent of a positive change into the retail price for unleaded fuel and only 24 per cent of a negative change. The difference in speed of adjustment is found to persist for more than ten days.

The paper then tests various theories that relate to the cause of price asymmetry in fuel pricing. The first theory is that consumer search costs explain the existence of pricing asymmetry: a lower proportion of 'shoppers' (those engaging in price search) leads to greater price asymmetry. The set of premium-fuel buyers is assumed to have higher search costs and a lower proportion of shoppers, leading to a prediction of higher levels of price asymmetry. Greater price asymmetry is found for premium fuel compared to regular fuel, on account of the slower adjustment to cost decreases. This is consistent with the predictions of the theory relating to the search costs of consumers.

The second hypothesis is that markets with less price dispersion show less price asymmetry: the greater the dispersion in prices, the greater the rewards for searching. A criticism of this hypothesis is that a more substantial search might decrease price-cost margins, generating less price dispersion. Comparing the results for firms located in markets with high or low price dispersion by quintile, Remer finds that the degree of asymmetry is much higher for markets with a low average price range, supporting the search-cost theory.

The third hypothesis is based on an alternative explanation for price asymmetry – focal-price collusion. According to this hypothesis, firms use the previous period's retail price as a focal point for collusion. If costs drop, then the previous period's price is maintained until a firm cheats. If costs increase, then firms raise their price to keep a positive margin and/or to be seen as not cheating. So retail prices would adjust more slowly to cost decreases than to cost increases.

Remer tests for focal-price collusion by testing whether, for pairs of firms that are close together, those that consistently price above the market average have more asymmetry than firms that price below the market average. Firms with a single competitor within 0.1 miles are the focus of this study, as they are assumed to be most likely to be able to engage in collusion. Remer finds no significant difference in the speed of adjustment between high- and low-priced firms. So firms in the dataset that have the highest purported potential for collusion and

consistently price above their competitors do not price more asymmetrically than firms that regularly price below their competitors. This does not support the hypothesis that collusion is a cause of asymmetric pricing.

'A Literature Review of the Size Effect', Michael Crain (29 October, 2011), available at SSRN: http://ssrn.com/abstract=1710076.

In the empirical literature on equity returns, numerous studies have found that firm size is a significant factor in explaining returns. On average, all else equal, small firms have higher returns than large firms. In his 1981 article 'The Relationship between Return and the Market Value of Stocks', Rolf Banz provided the first detailed evidence of the size effect, relying on US equity data from 1926 through to 1975.

The size effect represents a challenge to the Sharpe-Lintner CAPM, implying that the market premium factor is insufficient to explain equity returns. Researchers have not concluded that size per se drives equity returns; but, instead, size is regarded as a proxy for some other variables which affect equity returns. A number of theoretical explanations have been offered for the size effect. First, liquidity risk has been linked to size; and thus the higher returns to smaller firms may be explained by their greater liquidity risk. Second, size may be a proxy for 'information uncertainty', so the high returns of small firms may reflect the poor information that is available to their investors.

Since the early 1990s, at least some economists have expressed scepticism about the size effect, arguing that these findings may simply be an artefact of data mining. More recent studies have shown, moreover, that over the past few decades the size effect has fallen or disappeared. A number of studies using US data have documented that the size effect has diminished or disappeared since 1980. In his own empirical analysis, the author shows that, since 1981, smaller firms in the US have had more years of under-performance (relative to large firms) than over-performance.

Similar findings have been reported for other markets, including the UK, four global regions and 35 emerging markets. Where the size effect has been found to obtain, it tends to be concentrated in smaller firms – that is, the effect does not operate linearly across all firms. Moreover, it tends to be associated with 'the January effect' – the observation that returns are generally higher in January than other months. That, is the size effect tends to be most prominent in January.

Several explanations have been provided for the weakening of the size effect. One explanation is that the size effect may have diminished because knowledge of the effect has become widespread. Banz's seminal study, which demonstrated the size effect, appeared in 1981; and at least in the US, the size effect began to diminish in the 1980s. According to this explanation, knowledge about the size effect led to prices of small firms being bid up, which resulted in lower future returns. Moreover, in December 1981, a small-cap stock fund was launched. It has been argued that this fund ensured that it was easier to purchase equity in smaller firms, contributing to a change in the behaviour of their prices and returns.

'Dividend Policy in Regulated Firms', Francisco Bremberger, Carlo Cambini, Klaus Gugler and Laura Rondi, *MPRA Working Paper Series*, 48043, 11 June 2013.

This paper studies the impact of different regulatory regimes and modes of ownership on the dividend policy of regulated businesses. Using a panel of 106 publicly traded European electric utilities from 1986 from 2010, dividend-payout smoothing decisions are tested against different regulatory mechanisms.

In business operations, one of the most critical decisions faced by managers is determining both the amount and the variability of dividends. Over the past half century, many studies have observed that managers are concerned about the variability of dividends, and they seek to stabilise dividends over time, despite year-to-year volatility in earnings.

However, theoretical models of dividend determination, such as that presented in Modigliani and Miller's 1961 article, 'Dividend Policy, Growth and the Valuation of Shares', adopt a more benign view of dividend volatility, because 'dividends do not matter'. Optimal cash-flow management may mean that dividend volatility should track earnings volatility: when dividends are high, firms invest more and pay out large dividends; and when earnings are low, dividends are reduced so that firms can maintain working capital.

The contrast between theory and the revealed preference of managers on dividend-payout policy is a puzzle, and there are number of possible explanations. One is that managers perceive that the market places a premium on firms with a stable dividend policy. Other explanations are based on agency-cost theory that predicts the optimal behaviour of principals and agents when there is a separation of business ownership and control. For example, markets may require large and stable dividends so that there is less incentive for managers to spend free cash flows on projects that are net present value negative. Alternatively, managers may seek large and stable dividends to lengthen their tenure during downturns. The authors offer supplementary explanations which are specific to regulated firms. They argue that, for regulated

utilities, dividend policy also depends on the regulatory regime and whether the firm is owned privately or by the government.

The authors propose that, under cost-based regulation, the regulated price moves with ex post costs so that cash flows are more stable, whereas under incentive regulation, profits mostly depend on the firm's ability to achieve efficiency gains. Under such an incentive regime, the authors describe the firms as 'residual' claimants.

The authors use Lintner's dividend model, which is developed in his 1965 article 'Distribution of Incomes of Corporations among Dividends, Retained Earnings and Taxes', although they modify Lintner's partial-adjustment specification. The partial-adjustment specification is an equation that predicts current dividends by assuming that dividend payouts only 'partially' respond to year-to-year changes in earnings. The authors' modification to the partial-adjustment specification takes into account the potential regulatory effect of a policy change on firms' dividend behaviour.

The authors estimate the modified Lintner model of dividends for a panel of 106 firms from seventeen European countries operating in the regulated segments of the electricity market (from 1986 to 2010). The authors find that electricity utilities that are subject to incentive regulation are less likely to smooth their dividends. This behaviour implies that dividends are more responsive to earnings variability and more consistent with efficiency-enhancing pressures. However, only privately owned utilities engage in less dividend smoothing. Government-controlled firms continue to smooth their dividends despite moving from cost-based regulation to incentive regulation. The authors speculate that the stable dividends generated by government-controlled firms may be a covert way of enforcing political preferences.

'A Four-Factor Model for the Size, Value, and Profitability Pattern in Stock Returns', Eugene Fama and Kenneth French, SSRN-id22872021, June 2013.

Australian regulators have tended to estimate the cost of capital for utilities using the Sharpe-Lintner Capital Asset Pricing Model (CAPM). Under the CAPM, the cost of capital is estimated as the sum of the risk-free rate plus the product of the firm's systematic risk exposure (measured via beta) and the Market Risk Premium (MRP). The CAPM is effectively a one-factor model, where that factor is the businesses' exposure to the MRP. The CAPM can be contrasted with the Fama and French three-factor model (FF3), which determines the businesses' required rate of return as a function of three factors: the MRP, firm size, value. The FF3 can be seen as the CAPM with two additional factors. This paper explores whether another additional factor – over and above the three in FF3 – should be added to the model to account for profitability patterns in stock returns.

The paper identifies some of the drivers of the cost of capital: a lower stock price (and thus a higher book-to-market ratio) and higher expected future earnings both individually imply a higher expected stock return. Further, a higher expected growth in book equity due to the reinvestment of earnings implies lower expected earnings. As a result, it is expected that both profitability and a firm's level of investment affect the cost of capital. However, the paper notes that the firm's profitability and investment have been ignored in cost of capital analysis. This is because researchers in the past have not been able to determine the sequence of expected future earnings and expected investment. It is noted, however, that a 2012 paper by Novy-Marx has developed proxies for expected profitability of firms. As a result, Fama and French consider it appropriate to examine whether the FF3 should be augmented to include a profitability factor, effectively creating a Fama and French four-factor model (FF4). This paper examines the performance of the FF4.

The paper finds that the FF4 is rejected on the GRS test (which was developed in a 1989 article by Gibbons, Ross and Shanken), but for applied purposes it seems to provide an acceptable explanation of average returns.

Regulatory Decisions in Australia and New Zealand

Australia

Australian Competition and Consumer Commission (ACCC)

ACCC Does Not Object to Sydney Airport's Proposed Charges for Regional Airlines

On 15 August 2013 the ACCC issued its decision not to object to Sydney Airport Corporation Limited's proposed charges for regional airlines that serve passengers travelling within New South Wales. **Read about the ACCC decision.**

ACCC Consents to CBH Wheat Port Undertaking Variations

On 8 August 2013 the ACCC announced that it had agreed to Cooperative Bulk Handling Limited's (CBH) proposed changes to its capacity allocation system, which governs how CBH allocates shipping capacity to exporters using CBH's bulk-grain port terminals to export wheat from Western Australia. **Read about the proposed changes.**

ACCC Review of State Water's Regulated Charges 2014-17

See Notes on Interesting Decisions.

ACCC Commences a Review of the Domestic Transmission Capacity Service and Fixed Line Services

On 11 July 2013 the ACCC announced commencement of declaration inquiries for the Domestic Transmission Capacity Service (DTCS) and six fixed line services. **Read about the review.**

ACCC Consults on Variations to NBN Co Special Access Undertaking

On 4 July 2013 the ACCC released a draft variation notice setting out proposed changes to the Special Access Undertaking (SAU) offered by NBN Co. **Read the draft variation notice.**

ACCC Releases Revised Airport Quality of Service Monitoring Guidelines

On 26 June 2013 the ACCC issued revised guidelines setting out changes to the way the ACCC monitors service quality at Australia's four largest airports. **Read about the guidelines.**

ACCC Report on Telstra's Structural Separation Undertaking

On 21 June 2013 the ACCC tabled in Parliament its first report on Telstra's compliance with its Structural Separation Undertaking (SSU). The report outlines breaches of the equivalence and transparency measures that are contained in Telstra's SSU between 6 March 2012 and June 30 2012. **Read about the report.**

ACCC Does Not Object to Proposed Price Increases by Airservices Australia

On 14 June 2013 the ACCC announced that it does not object to a proposal by Airservices Australia to increase prices for some of its monopoly services, such as air traffic control, from 1 July 2013. Airservices Australia provides air traffic control and aviation fire-fighting and rescue services to airports and airlines. **Read about the proposal.**

ACCC Finalises Wholesale Prices for Broadband Services on Telstra's Copper Network

On 30 May 2013 the ACCC announced completion of its inquiry to set terms and conditions for the wholesale ADSL service. **Read the Final Access Determination.**

ACCC Commences Inquiry into Access to Mobile Networks

On 27 May 2013 the ACCC commenced a public inquiry to decide whether to extend, vary or revoke the domestic mobile terminating access service (MTAS) declaration, or whether to make a new declaration. Submissions were required by 5 July 2013. **Read the Media Release.**

Australian Competition Tribunal

Appeal by SPI Electricity Pty Limited [2013] ACompT 7

On 1 August 2013 the ACT published its Decision that the Appeal made by SPI Electricity against a Final Determination by the AER, be dismissed. **Read about SPI Electricity's 5 March 2013 Appeal.**

Application by Multinet Gas (DB No 1) Pty Ltd (No 2) [2013] ACompT 6

On 31 July 2013 the ACT published its Decision regarding the Multinet Gas application for review of

an access arrangement decision by the AER. **Read about the AER's decision.**

Application by Multinet Gas (DB No 1) Pty Ltd [2013] ACompT 5

On 5 July 2013 the ACT published the transcript of the hearing of an application by Multinet Gas for a review of an access arrangement decision by the AER. **Read about the application by Multinet Gas.**

Application by APA GasNet Australia (Operations) Pty Limited [2013] ACompT 4

On 5 July 2013 the ACT heard an Application by APA GasNet Australia, for a review of a full access arrangement decision by the AER. **Read about the hearing.**

Australian Energy Regulator (AER)

AER Releases Revised Network Service Provider Registration Exemption Guideline

On 29 August 2013 the AER released the revised Network Service Provider Registration Exemption Guideline and accompanying final decision. **Read the final decision.**

AER Guideline to Prevent Excessive Electricity Network Upgrades

On 23 August 2013 the AER published new consultation arrangements that apply when electricity distribution network businesses consider building new infrastructure. **Read about the new arrangements.**

AER Information Session on Draft Rate-of-Return Guideline

On 21 August 2013 the AER announced that it would hold an information session on the day of the release of its draft rate-of-return guideline and explanatory statement. The release was scheduled for 30 August 2013. **AER announcement here.**

AER Releases Amended SP AusNet Distribution Determination after Federal Court Order

On 16 August 2013 the AER amended SP AusNet's Victoria distribution determination 2011-15 by adjusting the regulatory asset base in accordance with Federal Court orders made on 20 December 2012, resulting in an increase to SP AusNet's revenues. **Amended SP AusNet Distribution Determination.**

Tribunal Affirms AER Decision to Reject Increases in SP AusNet's Smart Meter Prices

On 6 August 2013 the AER announced that the Australian Competition Tribunal has dismissed another legal challenge by SP AusNet to increase smart meter prices for the 2012-2015 period. The Tribunal affirmed the AER's decision in February 2013 to reject significant price increases sought by SP AusNet due to its choice of communications technology. **Read about the Tribunal's decision.**

AER Decision on SA Power Networks Cost Pass-through Application

On 31 July 2013 the AER released a decision regarding an application by SA Power Networks to pass through vegetation management costs arising from an unexpected increase in vegetation growth rates following the breaking of the drought in mid-2010. **Read about AER decision.**

AER Approves 2012 Demand Management Incentive Allowance Expenditure for Victorian DNSPs

On 9 July 2013 the AER announced that it had reviewed 2012 Demand Management Innovation Allowance expenditures claimed by the Victorian DNSPs: CitiPower; Jemena Electricity Networks; Powercor; SP AusNet and United Energy and had approved these applications. **Read about AER's approval.**

AER Approves 2013-14 Electricity Distribution Pricing Proposals for Non-Victorian Distributors – First and Second Tranches

On 31 May 2013 the AER announced its approval of the first tranche and on 7 June 2013 the AER announced its approval of the second tranche of the 2013-14 electricity distribution pricing proposals. **First Tranche** and **Second Tranche**

AER Approves Proposed 2013-14 Gas Tariff Variations and Cost Pass-through Proposals

On 28 May 2013, the AER announced it has approved the 2013–14 proposed annual tariff variations and cost past throughs for the non-Victorian gas distribution and transmission pipelines. **Read about the AER's approval.**

AER Releases Final Decision on South Australian Electricity Transmission Revenue

On 30 April 2013 the AER released its final decision on ElectraNet's revenue proposal for the five year regulatory period, 1 July 2013 to 30 June 2018. ElectraNet is the principal electricity transmission network service provider in South Australia. **Read about AER's decision.**

AER Final Decision on Murraylink Revenue

On 30 April 2013 the AER issued its final decision on Murraylink's proposed revenue proposal. Murraylink is the 220MW capacity interconnector that links the South Australian and Victorian regions in the National Electricity Market. Revenues will largely stay the same over the coming five-year period, from 1 July 2013 to 30 June 2018. **Read AER's final decision.**

AER Approves 2011-12 Demand Management Incentive Allowance Expenditure for non-Victorian DNSPs

On 29 April 2013 the AER announced its approval of demand management incentive allowance expenditures for 2011-12 for the non-Victorian electricity distribution network service providers. **Read about AER's approval.**

National Competition Council (NCC)

Revocation of Coverage of the Wagga Wagga Natural Gas Distribution Network

On 8 August 2013 the NCC sent to the NSW Minister for Resources and Energy its final recommendation regarding an application received from Envestra Limited for revocation of coverage of the Wagga Wagga natural gas distribution system. The Minister will respond by 6 September 2013. **Read the NCC announcement.**

Application for Coverage of the South Eastern Pipeline System

On 8 April 2013 the NCC submitted its final recommendation, that it does not consider that pipeline coverage criteria (a) or (d) are satisfied. **Read about the application process.**

Australian Energy Market Commission (AEMC)

New AEMC Chief Executive Appointed

On 20 August 2013 the AEMC announced the appointment of its new Chief Executive, Mr Paul Smith. **Read the AEMC Chairman's announcement.**

Review of National Frameworks for Network Reliability – Consultation Paper

On 12 July 2013 the AEMC released a consultation paper detailing a proposal for changes to the way network reliability is regulated and delivered. **Read AEMC What's New.**

Timeframes for the AEMC's Review of the National Frameworks for Distribution and Transmission reliability

On 4 July 2013 the AEMC announced the development of national frameworks for distribution reliability (due September 2013) and transmission reliability (due November 2013), following a request from the Standing Council on Energy and Resources. **AEMC What's New 4 July 2013.**

Issues Paper published for Advice on Best Practice Retail Price Regulation Methodology

On 14 June 2013 the AEMC published an Issues Paper for public consultation to commence development of its advice on a best practice method for the regulation of retail electricity prices for small customers. **Read AEMC announcement.**

Electricity Market Financial Resilience Interim Report

On 4 June 2013 the AEMC called for public submissions on draft recommendations to address risks that might arise following the financial distress or failure of a large retailer in the National Electricity Market (NEM). **AEMC What's New 4 June 2013.**

AEMC Publishes its Advice to SCER

On 3 June 2003 the AEMC published its advice to the Standing Council on Energy and Resources (SCER) on Consideration of Differences in Actual Compared to Forecast Demand in Network Regulation. **View the details.**

Australian Capital Territory

Independent Competition and Regulatory Commission (ICRC)

Regulated Water and Sewerage Services – Releases of Final Report and Price Direction

On 26 June 2013 the ICRC released its final report and price direction for water and sewerage services to apply from 1 July 2013. **Read the final report.**

New South Wales

Independent Pricing and Regulatory Tribunal (IPART)

IPART CEO James Cox to join AER

On 9 August 2013 the IPART announced the retirement after 21 years of its CEO and full time

Tribunal member, Mr James Cox PSM. **View the announcement.**

Solar Feed-in Tariffs 2013-14

On 28 June 2013 the IPART released its Final Report, following its investigation into solar feed-in tariffs. **Read the final report.**

Review of Regulated Electricity Retail Prices 2013-16

On 17 June 2013 the IPART released its final report on new pricing arrangements for the period 1 July 2013 to 30 June 2016. **Read the final report.**

Review of Regulated Gas Retail Prices 2013-16

On 17 June 2013 the IPART released its final report on new pricing arrangements for the period 1 July 2013 to 30 June 2016. **Read the final report.**

Draft Report – Review of Rental Arrangements for Communication Towers on Crown Land

On 30 April 2013 the IPART released a draft report in response to the October 2012 request from the NSW Government for a review of and recommendations on rental arrangements for communication infrastructure and equipment located on Crown land. **Read the draft report.**

Northern Territory

Utilities Commission

Determination Approval Target Standards 2014-19

On 12 July 2013 the Utilities Commission announced its approval of the distribution and transmission network performance target standards applicable to Power and Water Networks to apply from 1 July 2014 to 30 June 2019. **View the Determination Approval.**

Cost Pass-through Application – Final Determination

On 15 May 2013 the Utilities Commission released its final determination in response to Power and Water Corporation's Cost Pass-through Application. **Read the Final Determination.**

Electricity Retail Supply Code – Final Decision

On 23 May 2013 the Utilities Commission announced its final decision to amend the Electricity Retail Supply Code in accordance with the Final Decision Paper and amended Code. The amended code took effect on 1 June 2013. **Announcement of amended code.**

Queensland

Queensland Competition Authority (QCA)

2013 Blackwater Electric Traction Pricing DAAU

On 26 August 2013 the QCA published three submissions on the forecast volumes underlying Aurizon Network's 2013 Blackwater electric traction pricing draft amending access undertaking (DAAU). **View the submissions.**

Review Event 2013 – Central Queensland Flooding – Reference Tariff Adjustments

On 16 August 2013 the QCA announced that Aurizon Network has submitted a review event application relating to a pass through of the costs associated with flooding in central Queensland in January 2013. **QCA announcement.**

Queensland Rail June 2013 Draft Access Undertaking

On 28 June 2013, Queensland Rail submitted reference tariffs for the western system coal services, and proposed consequential amendments to its previously submitted draft access undertaking (the February 2013 DAU). **Read about the DAU.**

Long-term Regulatory Framework and Pricing Principles

On 28 June 2013, the QCA received a Ministerial Direction to investigate and develop a long-term regulatory framework (and pricing principles) for the monopoly distribution and retail water and sewerage activities of Unitywater; Queensland Urban Utilities; and Logan, Redland and Gold Coast City Councils. **Access the Minister's Direction.**

Regulated Retail Electricity Prices 2014-15

On 31 July 2013, the QCA initiated its review of regulated retail electricity prices for 2014-15 by releasing an Interim Consultation Paper. Submissions are due 6 September 2013. **Access the Interim Consultation Paper.**

Regulated Retail Electricity Prices 2013-14

On 31 May 2013, the QCA released its Final Determination on regulated retail electricity prices for 2013-14. **Read about the new prices.**

South Australia

Essential Services Commission of South Australia (ESCOSA)

Energy Retail Prices: Ministerial Pricing Report

On 30 August 2013 the ESCOSA released its first annual Ministerial Pricing Report on Energy Retail Prices. **View the report.**

Inquiry Into SA Water Pricing Reform

On 29 August 2013 the ESCOSA announced commencement of an Inquiry into possible reforms to the pricing of SA Water's drinking water and sewerage services. **Read about the Inquiry.**

Inquiry into Drinking Water and Sewerage Retail Services Pricing Reform

On 29 August 2013, the ESCOSA released a series of issues papers to give all members of the community the opportunity to provide input on any issues that they believe should be taken into account by the ESCOSA in this Inquiry. **View the submissions.**

Service Standard Framework for SA Power Networks for 2015-20 Period

On 26 August 2013 the ESCOSA announced receipt of written submissions in response to its consultation on the Issues Paper on the Service Standard Framework for SA Power Networks for the 2015-2020 regulatory period. **Read about the Service Standard Framework.**

Review of the Solar Feed-in Tariff Premium – Late Submission Received

On 7 August 2013 the ESCOSA announced receipt of further late submission in response to its review of the need for or nature of any future price regulation of the Feed-in Tariff (FiT) premium payable by electricity retailers to solar PV customers. **View the submissions.**

Draft Decision on Information Disclosure for No Early Termination Fee Market Contracts

On 1 July 2013 the ESCOSA received submissions in response to its 24 May 2013 Draft Decision on the need to develop an information disclosure guideline for energy market contracts with no early termination fees. This follows recent amendments to the Electricity (General) Regulations 2012 and Gas Regulations 2012. **View the submissions.**

Economic Regulation of Minor and Intermediate Water and Sewerage Retailers

On 28 June 2013 the ESCOSA released its Final Decision on the Economic Regulation of Minor and Intermediate Retailers of Water and Sewerage Services, to commence from 1 July 2013. **Read the Final Decision**

Final Determination of SA Water's Water and Sewerage Revenues

On 27 May 2013 the ESCOSA released its final decision on SA Water's revenues for the three-year regulatory period, 1 July 2013 to 30 June 2016. The decision sets out the maximum revenue per unit sold that SA Water can recover from its drinking water and sewerage customers over the regulatory period. **View the final determination.**

Tasmania

Office of the Tasmanian Economic Regulator (OTTER)

Approval of Standing Offer Electricity Prices to Apply from 1 January 2014

On 15 August 2013 the OTTER announced its approval of standing offer electricity prices that are to apply from 1 January 2014 when retail competition commences in the electricity sector. **View the announcement.**

Approval of Electricity Prices to Apply from 1 January 2014

On 21 June 2013 the OTTER announced its approval of Aurora Energy's increased electricity charges (applying to all residential customers and some small businesses) from 1 July 2013. **See Media Release.**

Tasmanian Water and Sewerage State of the Industry Report 2011-12

On 27 March 2013 the OTTER released the outcomes of its review of Tasmania's urban water and sewerage industry's performance during 2011-12. **View the report.**

Victoria

Essential Services Commission (ESC)

Proposed Changes to Regulatory Instruments Relating to Flexible Pricing

On 28 August 2013 the ESC released its Final Decision relating to regulatory instruments relating to

flexible pricing of electricity, following on from submissions to its June 2013 Draft Decision. **View the Final Decision.**

2014 Minimum Feed-in Tariff

On 5 July 2013 the ESC announced that it had been given the responsibility of determining the minimum feed-in tariffs for small-scale renewable energy embedded generation in Victoria and called for submissions by 25 July. **View submissions.**

VEET Scheme Expansion Guidelines Amendment – Draft Decision

On 3 July 2013 the ESC released a Draft Decision to advise Victorian Energy Efficiency Target (VEET) stakeholders of proposed amendments to the VEET Guidelines, in light of recent amendments to the *Victorian Energy Efficiency Act 2007*, and *Victorian Energy Efficiency Regulations 2008*. **View the Draft Decision.**

Water Price Review 2013-18

On 25 June 2013 the ESC released its final decision for the greater metropolitan water businesses (and on 18 June 2013 its final decision for regional urban and rural water businesses) having reviewed the prices to apply to water and sewerage services proposed by Victoria's water businesses for the regulatory period 2013-18. **View the outcomes of the review.**

Economic Regulation Authority (ERA)

ERA Develops Guidelines for the Rate of Return for Gas Transmission and Distribution Networks

See Notes on Interesting Decisions.

Gas Services Information: Determination of Allowable Revenue and Forecast Capital Expenditure for the Independent Market Operator 2013-14 to 2015-16

On 14 August 2013 the ERA announced receipt of a proposal for the Gas Services Information Allowable Revenue and Forecast Capital Expenditure for the Independent Market Operator, covering the initial Review Period from 1 July 2013 to 30 June 2016. **Read the proposal**

2013 Weighted Average Cost of Capital: Public Transport Authority, Brookfield Rail and The Pilbara Infrastructure

On 9 July 2013 the ERA announced it has calculated the weighted average cost of capital (WACC) for the Public Transport Authority, Brookfield Rail, and The Pilbara Infrastructure rail networks, as at 30 June 2013. **View the calculation.**

Publication Submission – The Pilbara Infrastructure Pty Ltd Floor and Ceiling Cost Determination

On 27 June 2013 the ERA published submissions received in response to its 27 May call for public comment on The Pilbara Infrastructure Pty Ltd's floor and ceiling costs determination for a section of the railway between Christmas Creek Mine and Port Hedland. **Read the submissions.**

2013-14 Price List Determination for Western Power's Electricity Network

On 26 June 2013 the ERA released a determination to approve a 2013-14 Price List submitted by Western Power to commence on 1 September 2013. **View the Determination.**

Final Decision – 2013 Energy Price Limits

On 11 June 2013 the ERA announced it has approved the Energy Price Limits proposed by the Independent Market Operator in its Final Report on 2013 Review of Energy Price Limits for the Wholesale Electricity Market in the SWIS, commencing 1 July 2013. **View the announcement.**

Proposed Variations to Western Power's Access Arrangement for 2012-13 to 2016-17: Price Control

On 4 June 2013 the ERA released its final decision on its proposal to vary Western Power's price control in its approved access arrangement for the third access arrangement period (AA3). **View the details of the final decision.**

New Zealand

Commerce Commission (CCNZ)

Commerce Commission seeks further feedback for UBA price review

On 13 August 2013 the CCNZ released an update paper on matters relevant to its price review of the unbundled bitstream access (UBA) service. The UBA price review started last year and the price will apply from 1 December 2014. The CCNZ expects to make its final decision in late October 2013. **View the Update Paper.**

Final Report on Auckland International Report

See Notes on Interesting Decisions.

CCNZ Identifies Companies Liable for $50 Million Telecommunications Levy

On 27 June 2013 the CCNZ released its determination of the amounts 26 telecommunications providers will pay towards the $50 million Telecommunications Development Levy (TDL) for 2011-12. On 20 May 2013 the CCNZ issued a Draft Determination concerning a levy allocation process for the telecommunications industry. **View the Media Release.**

Notes on Interesting Decisions

ACCC Review of State Water's Regulated Charges 2014-2017

On 5 August 2013, the ACCC published the pricing proposal submitted by the State Water Corporation for bulk-water supply in the New South Wales Murray-Darling Basin (MDB) for the 2014-17 period. The proposal contains State Water's proposed future prices for bulk water and its planned operating and capital expenditure over the 2014-17 period. State Water has used a 'building-block model' in determining its costs and has provided a 'quality assurance review report' with its proposal.

Under the Water Charge (Infrastructure) Rules 2010, the ACCC is required to consider State Water's pricing proposal and approve or determine its regulated charges for the three-year period from 1 July 2014. State Water's MDB charges were previously regulated by the NSW Independent Pricing and Regulatory Tribunal (IPART). Charges for services in State Water's areas of operation in NSW outside the MDB will continue to be regulated by the IPART.

State Water supplies bulk water to around 6200 customers in NSW. These customers include farms, irrigation corporations, local council town water suppliers and electricity generators. The ACCC held information sessions and pre-application consultation for State Water's customers in 2012 and early 2013 to explain the review process. Meetings with interested parties were held in Moree, Dubbo, Lithgow, Goondiwindi, Narrabri, Deniliquin, Condobolin, and Leeton. For the second stage of the investigation, the ACCC has published an Information Paper to provide background information on State Water's application to assist interested parties in making submissions and to outline the ACCC's review process. Submissions are due on 13 September 2013. **State Water Review**

ERA Develops Guidelines for the Rate of Return for Gas Transmission and Distribution Networks

The Economic Regulation Authority (ERA) is working towards establishing guidelines determining the rate of return on capital for regulated gas transmission and distribution pipelines in Western Australia. Under the Australian Energy Market Commission's recent changes to the National Gas Rules, the ERA is required to produce rate of return guidelines at least every three years. The guidelines development process provides an opportunity to undertake a comprehensive review of approaches for determining the rate of return on capital for regulated assets owned by gas transmission and distribution businesses in Western Australia. The first rate of return guidelines will be finalised by late 2013. There have been four steps in the ERA's process.

The first step in the ERA's consultation process was the publication of an Issues Paper in December 2012.

The second step, on 17 June 2013, was the release of a working paper for public consultation considering three alternative options for estimating the cost of debt in terms of their outcomes for economic efficiency. Interested parties were invited to make submissions on the working paper by 8 July 2013. Submissions were received from: Goldfields Gas Transmission Pty Ltd; Western Australian Treasury Corporation; APA Group; and Dampier Bunbury Pipeline.

Third, on 3 July 2013, the ERA held a workshop in Perth where a range of stakeholders participated, including representatives of regulated energy businesses and State authorities. The ERA then published a summary of the discussion at the workshop outlining the key topics and themes, including views expressed, without ascribing particular comments to any one individual or organisation.

Fourth, on 6 August 2013, the ERA published on its website the Draft Rate of Return Guidelines and the Explanatory Statement for the Draft Rate of Return Guidelines; setting out its proposed approach for determining the rate of return for gas transmission and distribution networks. Submissions are sought on the draft by 19 September 2013.

The ERA's first guidelines on rate of return for gas transmission and distribution networks must be finalised and published by the ERA by 29 November 2013. **ERA Rate of Return**

Final Report on Auckland International Airport

On 31 July 2013, the CCNZ released its report to the Ministers of Commerce and Transport on the effectiveness of the information disclosure regulatory regime under Part 4 of the *Commerce Act* in relation to Auckland International Airport. The CCNZ is required to provide its report to the Ministers in respect of each of the three regulated airports (Auckland International Airport, Christchurch International Airport and Wellington International Airport) as soon as practicable after any new price for

a regulated service has been set. Auckland Airport set new prices on 7 June 2012.

The CCNZ found that information disclosure regulation has had a positive influence on Auckland Airport's behaviour. In particular, it was effective in limiting Auckland Airport's ability to extract excessive profits. The report finds that Auckland Airport has made a number of positive changes to its price-setting approach since the information disclosure regulation has been in place. The CCNZ has estimated an acceptable range of rate of return of between 7.1 per cent and 8.0 per cent. Auckland Airport's targeted rate of return of eight per cent per annum for the 2013-2017 pricing period, is within this estimated range. The report also finds that: Auckland Airport has improved the way it sets prices to collect revenue for different services and from different consumers; that quality of service generally reflects the demands of airlines and passengers; and that innovation levels seem appropriate.

The CCNZ notes that its review does not make any recommendations about whether regulation, other than information disclosure, should apply to Auckland Airport; or whether information disclosure should continue to apply. It points out that this is outside of the scope of the review required by the legislation. The CCNZ describes 'information disclosure as the most light-handed type of regulation available under Part 4 of the *Commerce Act*'. **CCNZ Auckland Airport Media Release**

Regulatory News

Newest Working Paper

The ninth working paper in the ACCC/AER series is now available on the ACCC website. The paper is titled: **Estimating the Market Risk Premium in Regulatory Decisions – Conditional versus Unconditional Estimates**

The paper compares two methods for estimating the Market Risk Premium (MRP): (i) estimates using an historical average of excess equity returns; and (ii) estimates that are conditional on current information (such as volatility, interest rates and dividend yields).

It surveys the research literature on the debate about these two methods of estimation, identifying the key issues in the debate. It also points to some practical problems that regulators might face in implementing conditional estimates of the MRP.

New Working Paper on International Regulatory Institutions and Practice

The eighth working paper in the ACCC/AER series is now available on the ACCC website: **Country-based review**.

The paper is titled *Better Economic Regulation of Infrastructure – Country-based Review*.

The paper describes how and by whom decisions about the economic regulation of infrastructure services are made for seven key infrastructure areas: energy; telecommunications; postal services; water and wastewater; rail; airports and ports. It also profiles competition agencies.

It does this for seventeen countries with a chapter on the European Union to contextualise the eight EU member states profiled. The chapter for each country contains essential background on its geography, economy, polity and legal system.

The eighteen chapters are, in order: South Africa; Japan; Singapore; South Korea; Australia; New Zealand; the European Union; France; Germany; Ireland; Italy; the Netherlands; Spain; Sweden; the United Kingdom; Canada; Mexico and the United States.

The paper is the first-stage report on the project *Better Economic Regulation of Infrastructure – International Insights*.

It is planned to publish a second-stage report before the end of the year. It will be an interpretative report, bringing out some themes and insights from the work that should be useful for anyone contemplating the design of regulatory and competition institutions and processes.

ACCC/AER Regulatory Conference

The presentations made at the 2013 ACCC/AER Regulatory Conference are **now available**.

New Zealand Commerce Commission Conference, 17-18 October 2013

The New Zealand Commerce Commission will hold a conference in Wellington, *Competition Matters*, on 17 and 18 October 2013. **View conference details.**

Network is a quarterly publication of the Australian Competition and Consumer Commission for the Utility Regulators Forum. For editorial enquiries please contact Rob Albon (Robert.Albon@accc.gov.au) and for mailing list enquiries please contact Genevieve Pound (Genevieve.Pound@accc.gov.au).