

A New Approach to Regulatory Pricing

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Over the last twelve years, independent, expert and transparent scrutiny of the water industry has produced tangible benefits for customers. The evidence is clear. Independent economic regulation has brought a much clearer focus on performance and prices to the Victorian water industry. While these successes are notable, they do not imply or justify complacency. More can be done to promote efficiency and the outcomes valued by customers. For this reason, the Essential Services Commission (Victoria) has embarked on a wide ranging review of the design of the economic regulatory framework it administers.

The economic regulation of utility businesses is predicated on a single, simple proposition: Regulated businesses will endeavour to outperform the regulator's revenue determination in the pursuit of profits or discretionary funds. But, what if this proposition does not hold as strongly as typically assumed?

Since 2004, the Essential Services Commission (Victoria) has been charged with determining the revenues, prices and performance standards of 19 state-owned water businesses. These businesses differ significantly in their geography, customer base, service responsibilities and revenue requirements. After three rounds of price reviews over the last twelve years, experience suggests that the basic proposition of economic regulation may not hold as firmly in this sector as in others.

One Managing Director was known to share the view: 'I love economic regulation. The ESC tells me how much money I have and then I go out and spend it.'

Then there was the Chairman who said, 'After we've prepared our five year price submission, there's really not much else left for the Board to do.'

Other water authorities have openly confided that their submissions contained projects they knew to be 'duds'. Apparently, the businesses took the view that it was easier to defer the fate of these projects to the regulator rather than having the required debates internally.

Then there was the water business that printed on its customers' bills that the rise in prices was approved by the Essential Services Commission and recommended that customers contact the Commission if they had any concerns.

Another central proposition in support of economic regulation holds that pursuing economic efficiency promotes the long term interests of consumers. Economic regulators deliver fair and reasonable prices for customers by creating incentives promoting efficient expenditure and prudent investment by the firms they regulate. But this proposition is just an assumption. Despite the efforts of regulators to promote economic efficiency by deploying the tools at their disposal, do customers agree that the outcomes achieved are in their long term interests or the prices they pay are fair and reasonable? At best, the answer might be a diffident, 'Maybe'.

Economic regulation as currently practised around Australia focuses on the relationship between the regulator and the regulated at the near-exclusion of customers. While economic regulators dutifully comply with their statutory obligations to consult publicly on their proposed decisions, customers have typically been seen as largely passive recipients of regulated services and regulatory decisions.

More recently, regulatory processes here and abroad have sought to engage consumers by establishing consumer reference groups, challenge panels or professional consumer bodies. While each approach

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differs in its design, most share the goal of trying to expand the previous bilateral process into a tripartite discussion. Without doubt, it is noble of regulators to invite customers into the regulatory 'tent'. What is less clear is whether any healthy-minded customer would really want to be in that 'tent'.

And, in reality, they're not in the 'tent'. Regulator-inspired customer boards, panels and bodies don't really engage customers. These mechanisms don't engage real customers; real people. These mechanisms only engage the people who seek to represent 'the people'. As such, boards and panels and bodies are only acting on their impressions of the interests of customers. No matter how well informed it might be, representative impressionism is merely that. It involves one group of people representing their impression about the interests, priorities and concerns of other people. It unavoidably merges customers' interests with the interests (and agendas) of those doing the representing. In truth, only customers can represent their own interests.

How are economic regulators to respond if the two central propositions of their craft do not hold or if they only hold weakly?

A paper released in May 2016 sets out a proposed response to this rather existential question. The paper explores how the existing approach to regulating prices in the water sector might be modified. The paper is now the subject of consultation. The aim is to bed down the new framework by the end of this year so that it guides the next round of price determinations in 2018.

Framework Objectives

In developing the new approach, four high-level objectives were set. These objectives centred on: Customers, Autonomy, Performance and Simplicity. Each objective is discussed below. This is followed by a brief description of the proposed framework.

Customers

Customer consultation is in fashion and the Victorian water industry is conforming spiritedly. There has been a marked improvement in the businesses' interests and efforts in engaging with their customers. In preparing their last price submissions, the State's water authorities challenged themselves to find new and innovative means for consulting with their customers. As the regulator, those efforts were welcomed enthusiastically (or as least as enthusiastically as regulators ever get). However, most of this consultation focused on informing customers of the water businesses' plans prior to their submission to the regulator. There was little or no opportunity for customer feedback to shape those

plans. Customers were still being seen as recipients rather than economic participants.

As the economic regulator we must accept our share of responsibility for this outcome. The technical nature of the regulatory model disenfranchises customers. It encourages water businesses to invest their time attending to the regulator and its requirements, leaving customer consultation as the final tick-box to be checked prior to making a submission.

The framework will pivot the businesses' attention squarely towards their customers. Businesses will not be able to make a submission to the regulator without having consulted with customers before, during and after the development of their plans. But consultation is just a process. The framework seeks to move away from the regulatory obsession with defining processes. Instead, the water businesses will be required to express their entire proposals in terms that reflect the outcomes they will be delivering to their customers. The future will be about customer outcomes rather than regulatory gratification. There will be no successful regulatory outcomes for the businesses if they do not couch their proposals in terms that reflect the concerns, priorities and preferences of their customers.

And here an important distinction lies. The ESC is not looking to bring customers into its regulatory processes. That would be a misconceived outcome. Customers care about the services they get and the prices they pay. Services come from water businesses and payments are made to water businesses. The economic regulator does not feature in that relationship. Nor should it. Nor will it under this proposal.

To be clear, the objective in placing customers rather than the regulator at the centre of the regulatory framework is not motivated by some 'new age' principle about recognition or respect. It is motivated by basic economics. Only customers know their preferences. Water businesses must discover those preferences and then they must seek to align their outputs with those preferences in order to achieve the most socially efficient outcome possible. For too long, economic regulation has been focussed on the pursuit of technical efficiency. Allocative efficiency is rarely mentioned. Economic regulation focusses on driving the production of services to its efficient cost. It doesn't stop to ask whether these are the services that customers want or for which they are prepared to pay. That will no longer be possible under the proposed framework.

Autonomy

As the anecdotes at the start of this article highlight rather colourfully, the current framework either allows or encourages lines of responsibility for outcomes to be blurred. Water businesses are often confused about the Commission's role. The reason for this confusion is not clear — but there should be no misunderstanding. The Boards and their management teams are solely responsible for the outcomes they deliver. The proposed framework leaves no doubt about the autonomy of the water businesses to determine their financial and reputational fates.

In consultation with their customers, water businesses will decide on the services to be delivered, the trade-offs to be considered (including between different customer groups) and the prices to be paid. Boards will determine the risk their businesses assume on behalf of their customers. Boards will hold management to account for the quality and accuracy of their proposals and for delivering the outcomes to which they are proposing to commit. These are matters for the Boards. The regulator has no role in these decisions. The Boards are autonomous in these decisions.

And having made and committed to those decisions, each Board will be responsible for self-assessing the level of ambition of its pricing proposals. Because the rate of return a business earns will be determined by the ambition of its proposal, each Board will be responsible for assessing the rate of return it earns in the coming regulatory period. Responsibility is the corollary of autonomy.

Performance

Service standards and performance reporting are key features of economic regulation. There have been marked improvements in reported outcomes across the water industry since the inception of economic regulation. More recently, that trend towards improvement has stalled with a clustering of performance across most measures. It would seem the businesses have little interest in 'breaking from the pack'. They seem to have settled into a cosy equilibrium in which there is little ambition to do better.

There are two implications to be drawn from this observation. First, there are no real consequences for the water businesses from sitting in the 'pack'. There are no rewards for improvement and no sanctions for slippage. Second, the reported performance measures may not mean much to anyone outside the businesses. These may not be the outcomes that matter most to most people. So, who cares if progress stalls?

This will change under the new framework. The framework will provide incentives for ambition in the delivery of services and it will focus on the outcomes that matter to customers rather than regulators, engineers, accountants and sustainability managers.

By ending the enforced one-size-fits-all approach to performance reporting, businesses will be required to work with their customers to identify the outcomes that matter most to them. Businesses will have the autonomy to diverge in the outcomes they pursue — and in doing so, they will face far stronger incentives to operate innovatively. Irrespective of whether the accusations levelled against economic regulation are warranted, there will be no excuses for a lack of innovation under the new framework.

Simplicity

When it comes to engagement between regulators and the parties they regulate, complication has proven to be a successful strategy. More details, more formulas, more voluminous submissions, and decisions that are written in anticipation of appeal have become the 'norm'. One complication begets another and before long, no-one is fully in control of the outcome and no-one is fully capable of understanding it.

Over the last decade, the Essential Services Commission (Victoria) has worked assiduously to ensure the Victorian framework for water pricing does not descend into this madding pursuit of false precision. This is not for the lack of trying by some regulated entities, but it was never shown to serve the interests of consumers. What benefits do consumers gain from contests over the 'correct' value of beta, gamma or the market risk premium? None. What benefit do customers gain from introducing performance measures that don't relate to service outcomes? None. What benefits do consumers gain from regulators and regulated businesses bickering over such arcane matters? None.

No regulatory framework can completely prevent such distractions. The proposed framework at least attempts to foreclose on those matters that make little difference to the outcomes experienced by customers. It seeks to achieve this by choosing simplicity wherever possible.

Overview of the Model

The proposed pricing framework introduces new financial, reputational and procedural incentives to create a better alignment between the interests of water businesses and the customers they serve. Under the new approach, the returns earned by a water business will be linked to the level of ambition expressed in their price submissions. Importantly,

the ambition of a price submission is not the same as the broader ambitions that the water businesses might hold. Water businesses may hold ambitions for their reputations or their organisational culture. They may be concerned about the role they play in their communities or the impact they are seen to have on the environment. These broader ambitions are of no concern to the regulator unless they reflect statutory or regulatory obligations on the water businesses.

The ambition of a price submission will be measured against criteria that are directly linked to the value received by paying customers. The framework will reward businesses that focus on delivering the outcomes sought by their customers and doing so as efficiently as possible. In response to the rigidities and one-size-fits-all constraints of the current pricing model, the new framework also introduces a suite of new flexibility mechanisms.

The Centrality of Customer Engagement

Despite the very strong emphasis the framework places on water businesses engaging with their customer, the guidance to water businesses regarding the nature of their consultation will remain non-prescriptive. Each business is much better positioned than the regulator to determine how to work most effectively with its customers.

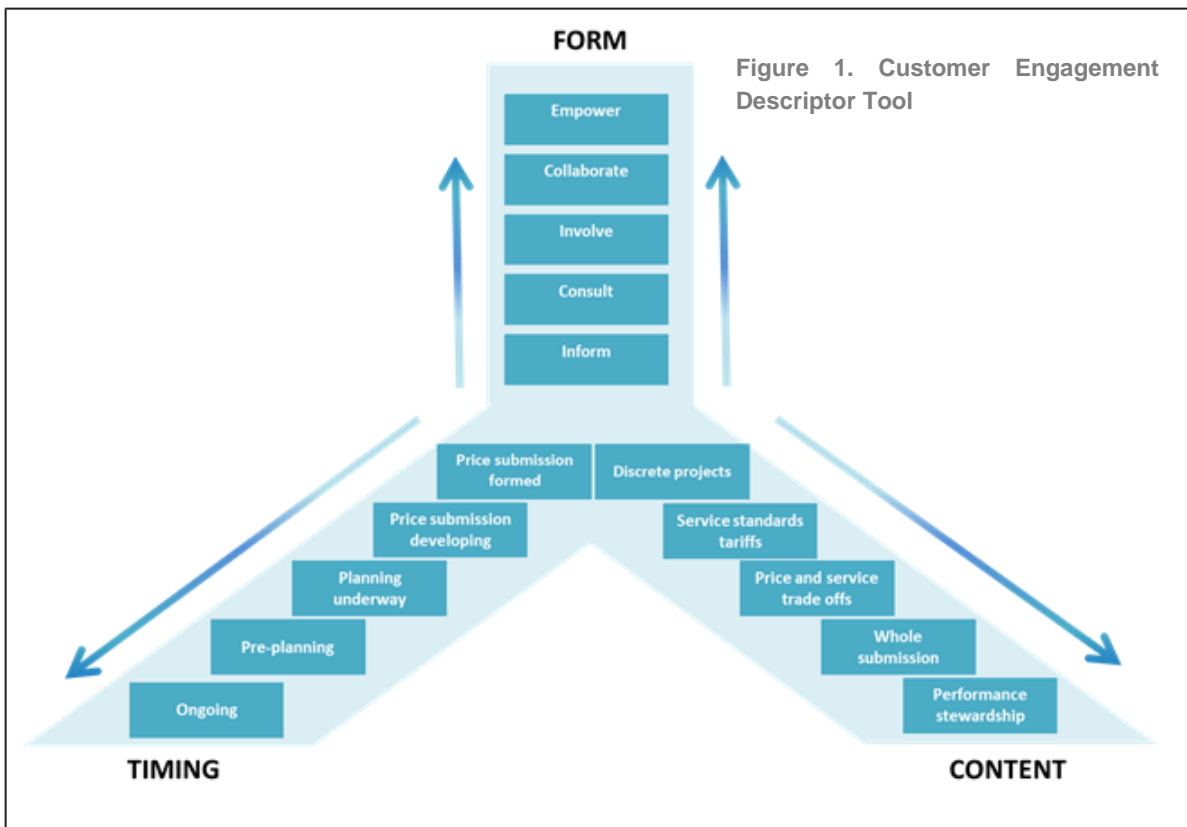
Instead, the framework adopts a principles-based approach to regulation. Each principle is high-level and provides scope for the water businesses

to exercise discretion when considering how to comply with their regulatory obligations. Perhaps the most notable of these principles is the one that requires price submission to demonstrate how a water business 'has taken into account the views of its customers.'

The term 'taken into account' is of key importance. It makes clear to the boards and management of the water businesses that they alone are responsible for the decisions they make in compiling their price submissions. While the new framework requires a concerted effort by the businesses to consult and engage with their customers, there is no room for poor decisions based on the excuse that, 'That's what our customers wanted'. The framework makes clear that Boards are autonomous and therefore, they will be held accountable for how they exercise their discretion.

How each water business chooses to consult with its customers will similarly be at its discretion, but price submissions will need to justify the form of consultation taken; show what has been revealed during that consultation; and explain how that knowledge has informed the price submission (including where the water business won't be satisfying customer expectations).

While the framework does not prescribe the nature of the consultation to be undertaken, a tool has been developed that water businesses can use to describe their efforts (Figure 1). The tool recognises three



elements of customer engagement: form, content and timing. The outward pointing arrows reflect expectations that earlier, deeper and broader engagement will provide water businesses with greater insights about the interests, priorities and concerns of their customers.

Form refers to customers' involvement in decision making. It describes how customers and water businesses engage with each other. It is derived from the IAP2 Public Participation Spectrum. The scale consists of five types of participation, ranging from 'inform' to 'empower'.

Content refers to the matters discussed as part of the consultation program. The most basic level involves consultation on a small number of specific issues or projects. At the next level, it might include multiple initiatives, such as exploring service standards and targets, guaranteed service levels, and tariff structures. At the highest level, consultation might involve the exploration of price and service trade-offs involved in assembling a price submissions.

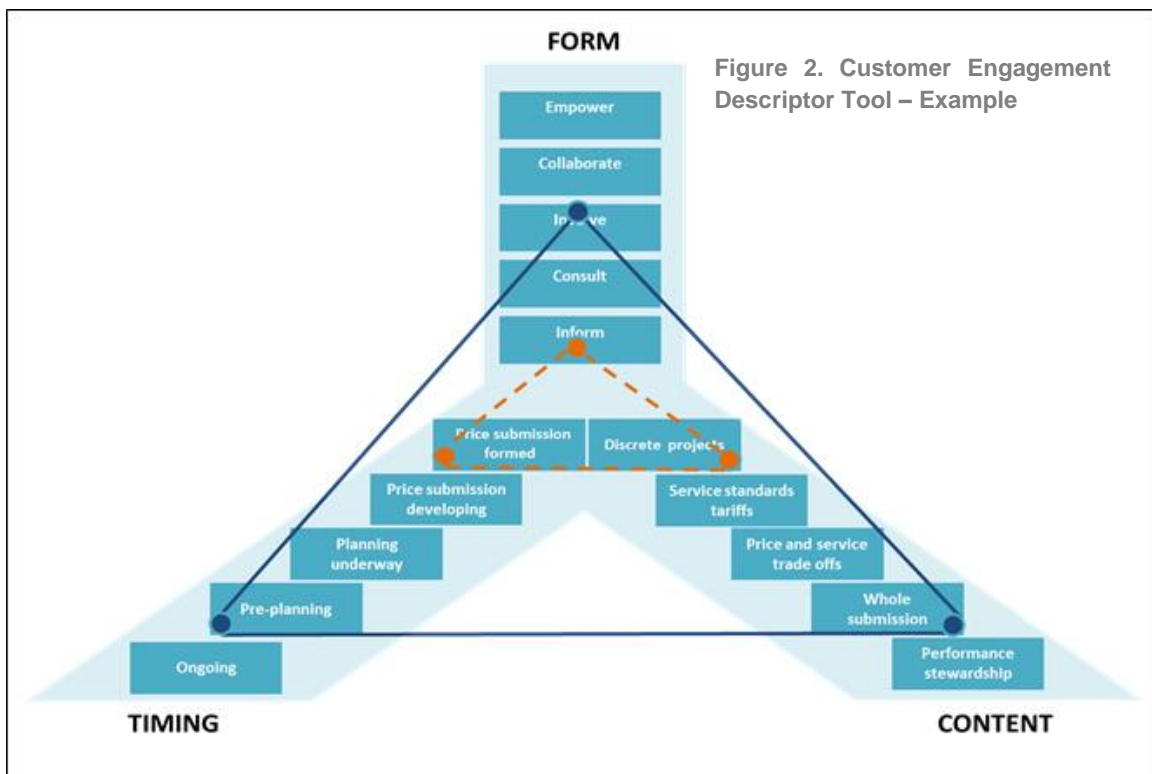
Timing refers to when consultation takes place. Clearly, the later customers are involved, the less their influence will be in framing a price submission. Earlier and ongoing involvement of customers is assumed to provide businesses with the greatest insights about their customers' expectations.

In Figure 2, the tool is used to describe two different consultation exercises. The blue (solid) triangle represents a business involving its customers in the development of most parts of the price submission from an early stage. The orange (dashed) triangle represents a business essentially sharing a completed price submission with its customers who have little influence over the outcomes being proposed. Under the new framework, more expansive consultation efforts (that is, bigger triangles) are likely to require less intrusive scrutiny by the Commission.

Engagement ≠ Consultation

While it is common practice to treat the terms consultation and engagement as synonyms, the new framework makes an important distinction. Consultation is a process. Engagement is way of thinking. Consultation is a process involving customers. Engagement is way of thinking about customers.

Engaging with customers does not mean sitting in a room chatting with them. For businesses to demonstrate they are engaged with their customers, their price submission will need to demonstrate an occupation with the interests, priorities and concerns of those customers. The businesses will need to tell their 'stories' from inside the mind of the customer. The most successful price submissions will be those that can tell a story as though it were being told by customers. It should be the story that customers would want to tell.



A New Incentive Framework – PREMO

A central feature of the new framework is linking of the rate of return that a water business can earn with the level of ‘ambition’ shown in its price submission. The rate of return will increase with the level of ambition.

Under the new framework, a weighted average cost of capital (WACC) will no longer apply uniformly to every water business. The framework departs from the capital asset pricing model which has applied in Victoria’s water sector since the commencement of economic regulation. In future, each business’s regulated return on equity will be linked to the tangible outcomes it delivers to customers. This will be achieved by allowing the regulated return on equity to vary according to the level of ambition shown in a price submission. Ambition will be assessed against five elements: Performance, Risk, Engagement, Management and Outcomes (PREMO).

Performance – have the performance outcomes to which the businesses committed in its price submission been unmet or exceeded? (see below: New Flexibility Mechanisms)

Risk – has the business sought to accept more or less risk on behalf of customers?

Engagement – how effective was the business’s customer engagement (or, how large is the engagement triangle in Figure 2)?

Management – is there are strong focus on efficiency? Are controllable costs increasing, staying the same, or decreasing?

Outcomes – do proposed service outcomes represent an improvement, the status quo, or a withdrawal of service standards?

In the first round of price reviews under the new framework, it is proposed to use the PREMO assessment criteria to rate price submissions into one of four categories: ‘leading’, ‘ambitious’, ‘standard’ or ‘basic’. The highest return on equity will be earned by businesses with ‘leading’ price submissions.

Establishing the Return on Equity under PREMO

Later this year, the Commission will publish its guidance material for the next price review. This will include the PREMO assessment criteria and the range of values for the return on equity.

A ‘basic’ submission will be assessed as one reflecting deteriorating outcomes for customers in terms of service outcomes, operating efficiencies or both. In light of these poor outcomes, the return on equity for ‘basic’ price submissions will be set at a

level commensurate with the benchmark real cost of debt. This ensures that relevant water businesses can, at the least, recover interest costs associated with funding capital investment but it provides no return for the shareholder. This rate should remain fairly constant over time and close to the long-run average cost of debt. At this stage, the return on equity expected to be allowed for a ‘basic’ price submission will be around 4.1 per cent (real).

The return on equity allowed for a ‘standard’ price submission would be slightly higher. A standard submission by-and-large reflects a business-as-usual set of outcomes for customers, therefore the allowed return on equity would be largely unchanged from the one expected under the current framework. At this stage, it is expected that the return on equity allowed for a ‘standard’ price submission will be around 4.5 per cent (real).

More ambitious submissions would receive a higher allowance for the return on equity. Because PREMO is a new model, a relatively narrow range for the return on equity in the 2018 price review is proposed. For example, the return on equity at the top of the range might be only 1.2 per cent higher than the bottom of the range. That is, a ‘leading’ price submission might earn a return on equity around 5.3 per cent. ‘Ambitious’ price submissions would earn something less, say, 4.9 per cent (real).^{1,2}

The increasing rate of return provides an incentive for businesses to be as ambitious as possible. In addition, these ratings are likely to provide reputational incentives for water businesses to propose and efficiently deliver outcomes that are valued most by their customers.

Best and Final Offers Only

The third key design feature of the new framework is the encouragement it provides water businesses to make price submissions that reflect their ‘best and final offers’. This is achieved by requiring the businesses to self-assess the level of ambition of their price submissions against the PREMO framework. These self-assessments will be submitted along with the price submissions to the Commission which will then conduct its own, independent assessment. The Commission will apply the same criteria (which it will have previously

1 A return on equity of 4.9 per cent rather than 4.5 per cent, is generally equivalent to around 0.5 to 1.5 per cent of revenue, depending on the business.

2 The size of the range, the number of categories, and the size of the gaps between categories could change as familiarity with PREMO increases, or if the Commission wants to modify the incentive properties in the framework.

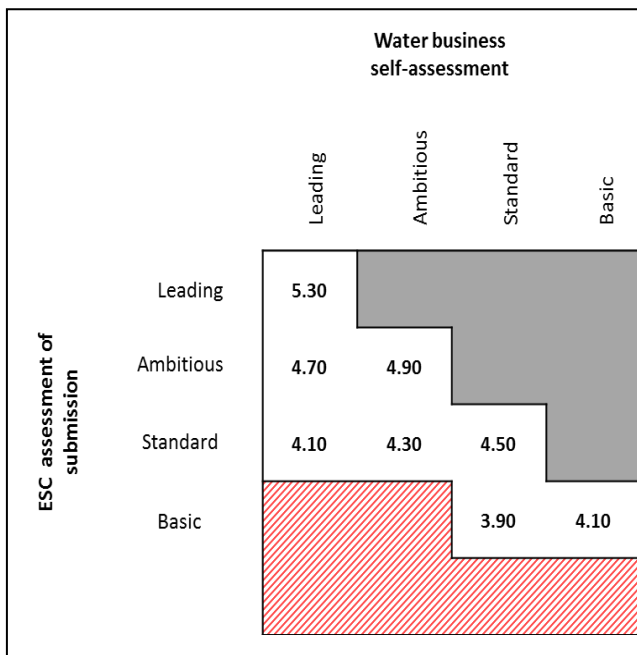
published) to assess the level of ambition of each price submission.

The best outcomes for a water business will be achieved when the Commission and the business align in their respective assessments. Situations of aligned assessments are represented by the upper diagonal of the matrix shown in Figure 3. The more ambitious the submission according to both the business and the Commission, the greater will be the allowed return on equity.

The grey shaded area above this diagonal indicates the Commission will never assess a price submission more favourably than the water business's self-assessment. This provides an incentive for the business to provide an honest assessment of its submission. However, if a business overstates its rating (that is, the Commission finds it qualifies for a lower rating), then the business will receive a lower return on equity than it sought. This can be seen in the diminishing values in each column in Figure 3.

But water businesses have an even more powerful (financial) incentive not to overstate their level of ambition. If the Commission finds a water business has overstated its ambition, then the return on equity will be lower than had the water business accurately assessed itself. This can be seen in the diminishing values moving left along each row in Figure 3. This design feature penalises water businesses that seek to 'bluff' the regulator.

Figure 3: PREMO Matrix – Allowable (real) Return on Equity



The (red) shaded zone at the bottom of the matrix represents an area within which the Commission will reserve its discretion. For example, it may require the water business to resubmit its proposal or approve a shortened pricing period.

Together, the design features of the matrix provide the businesses with a strong incentive to assess their price submissions accurately and honestly. Put in more business-oriented terms: The framework requires water businesses to submit their 'best and final offers' and not to be lured into making ambit or inflated claims.

New Flexibility Mechanisms

Three new flexibility mechanisms have been included in the new pricing framework. These include: a flexible approach to performance measures, in-period reviews of performance and the allowed return on equity, and a fast-track option for high quality submissions.

As with the existing framework, businesses will be expected to propose performance measures and service standards against which they will be held accountable. Whereas in the past these measures have been largely determined by the business and the regulator, in the future these measures will be informed by customer consultation. As a result, different businesses may adopt different measures; and some businesses may even adopt different measures in different regions or towns within their districts. The Commission will maintain some common measures but will encourage businesses to innovate to reflect the specific interests of their customers. Water businesses will be required to self-report to customers on their performance against their commitments.

The second new flexibility mechanism involves the opportunity for price submissions to be fast-tracked through the Commission's price review process. Under the new framework, we expect that high quality price submissions that comprehensively and clearly comply with our guidance material will require less intrusive regulatory scrutiny. Businesses that prepare high quality price submissions will be rewarded through the reputational benefits associated with fast-tracked submissions. It will also allow these businesses to focus on delivering services rather than having management time dedicated to regulatory processes. This will also enable the Commission to focus its resources on investigating price submissions that require closer and more rigorous scrutiny.

A third flexibility mechanism provides for instances where, under the PREMO assessment framework, businesses or the Commission might want to revisit

the return on equity that was allowed during a price determination. In the event that the Commission approved a price submission with a rating of 'leading' or 'ambitious' but performance fell short during the regulatory period, the Commission would reserve the option of revisiting and down-grading the allowed rate of return during the period. Customers cannot be expected to pay for outcomes they do not receive. Conversely, if the Commission down-graded a submission during the price review process, but the business subsequently demonstrated it could deliver its original commitments, the business could apply for a reassessment of its level of ambition during the regulatory period.

Other New and Unchanged Features of the Building Block Model

In consultation with their customers, the water businesses will determine the performance outcomes and service standards they intend to deliver. As occurs now, each business will then forecast the revenue it requires to deliver these outcomes efficiently as well as any obligations set out in policy or by technical regulators (such as environmental and health standards). As in the past, prudent and efficient operating costs as well as tax will be recovered by water businesses via prices in the year that they are incurred. Prudent and efficient capital costs will be added to the regulatory asset base (RAB), which will continue to be indexed to inflation. Water businesses will recover a return of their investment via regulatory depreciation, and a return on the RAB. The return on the RAB will continue to be calculated using a 60:40 debt to RAB benchmark ratio, and on a real post-tax basis.

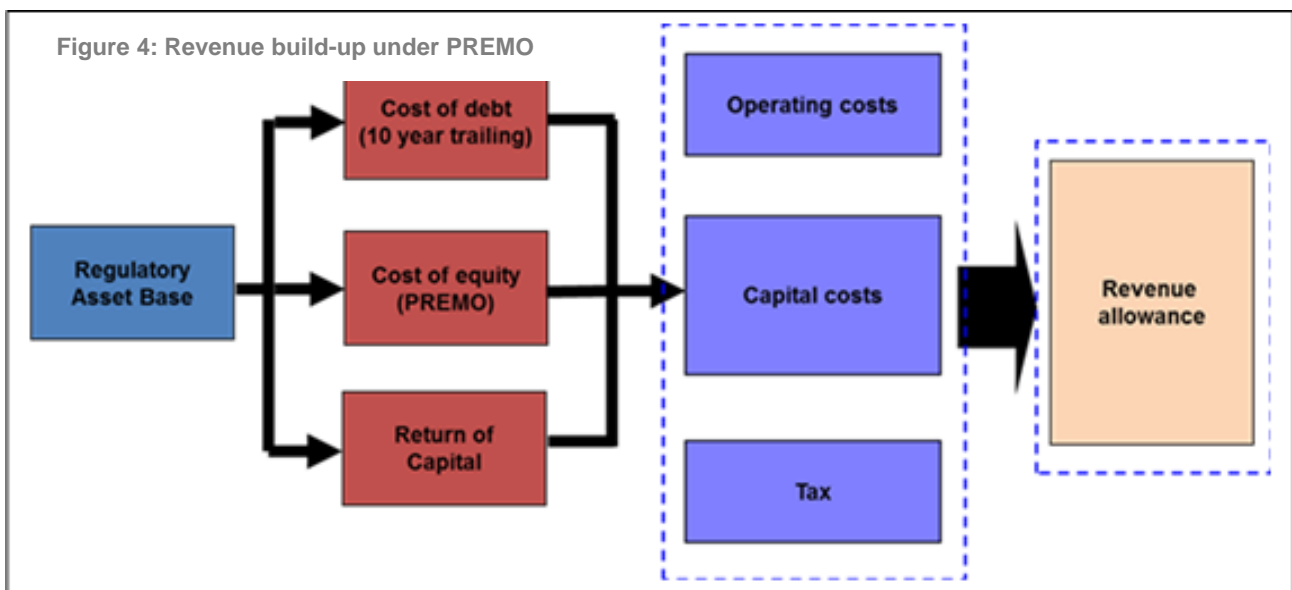
The other two significant departures from the previous approach to the building block model relate to the allowed return on equity and the allowed return on debt. As described above, the return on equity will reflect the ambition of a price submission as assessed under the PREMO framework. While the Commission will continue to use a benchmark for the cost of debt, it will now be calculated based on a ten year trailing average approach (rather than the 'on the day' approach that has been used till now). This figure will be updated annually. This will reduce the possibility of sharp price fluctuations in response to changed financial market conditions.

A summary of how the revenue allowance will be established is provided in Figure 4.

Conclusion

There are three regulatory mechanisms that thread their way through the proposals and bind them into a comprehensive framework. These are: Engagement, Incentives and Accountability. These mechanisms are familiar to economic regulation but they are given new expression in the proposed framework.

In the future, it will not be possible for water businesses to prepare price submissions for Commission consideration without having meaningfully engaged their customers' interests, concerns and priorities. This requirement won't be just a procedural nicety. Submissions will need to be expressed in terms of the outcomes valued by those customers. There will be no satisfactory regulatory outcomes for a water business that fails to demonstrate the primacy of its customers' interests.



Although the traditional incentive mechanisms of economic regulation have proven beneficial in the Victorian water industry, more can be done. By linking the level of ambition of a pricing proposal to the rate of return a business will earn, the new framework will establish a new set of strong financial and reputational incentives. The framework will reward businesses that focus on delivering the outcomes sought by their customers and doing so as efficiently as possible, while accepting the risks involved.

Being customer-facing entities, the water businesses will be accountable for fulfilling their part of the economic bargain. They will be responsible for discovering their customers' preferences. They will be responsible for determining how ambitious they wish to be when responding to those preferences. And uniquely, businesses will be responsible for self-assessing the extent of their ambition. Under the new framework, the regulator's role can be portrayed as assessing the accuracy and veracity of the businesses' self-assessments. The rate of return businesses earn will depend on the consistency between these two assessments.

Engagement, Incentives and Accountability are not new to economic regulation but the framework imbues these mechanisms with renewed vitality. The renewal of economic regulation is not an end in itself, but it is an incumbent responsibility to ensure that frameworks continue to promote the long term interests of consumers. This is *our* unending responsibility.

Critical Issues in Regulation – From the Journals

PC Productivity Update 2014-15, Productivity Commission, 26 April 2016.

The Productivity Commission (PC) **publishes** an annual productivity update analysing Australia's productivity performance for the previous year (in this case, 2014-15). The study is based on the latest Australian Bureau of Statistics (ABS) annual estimates of multifactor productivity (MFP) and labour productivity (LP) growth for both the twelve-industry market sector as a whole, and for each of its twelve individual industries. It also includes some observations on long-run productivity trends.

In 2014-15, MFP improved in seven of the twelve industries in the market sector. These industries include Electricity, gas, water and waste services (Utilities) (2.5 per cent) and Information, media and telecommunications (4.5 per cent). In 2014-15, MFP growth in the Utilities industry was associated with a 1.4 per cent growth in output and 1.1 per cent decline in total inputs. Input of labour fell by 5.9 per cent and capital grew by 1.6 per cent (down from 2.7 per cent in the previous year) – there was a 7.8 per cent increase in measured LP. On the other hand, another category associated with utilities (Transport, postal and warehousing) was one of the five industries experiencing negative MFP growth in 2014-15 of –3.9 per cent.

In terms of Australia's international ranking, the PC observes that this has been increasing since the early 1990s. This improvement has been linked to sustained economic reforms during the 1980s and 1990s, including: the opening up of trade and capital markets to competition; partial deregulation, commercialisation and privatisation of state-owned enterprises; labour market reforms; and National Competition Policy. These resulted in better utilisation of labour and capital by business, and enabled the Australian economy to innovate, taking advantage of newly-developed information and communication technologies.

Vertical Unbundling and the Coordination of Investment in Electric Systems: On 'Cheap Talk' and Deep Charging, Gert Brunekreeft and Nele Friedrichsen, *Competition and Regulation in Network Industries*, March 2016, pp. 378-403.

This article analyses the problem of investment coordination in a vertically separated electricity supply industry where pricing is on a locational basis. Where investments in networks and generation need to be coordinated, this cannot be done within the same business. Information exchange might achieve

coordination, but only if truthful information is exchanged. The authors use a model to analyse this, and conclude that perverse incentives mean that this will not generally be the case.

The analytical approach is based on a model where there is a regulated monopoly network and two generators that interact according to Cournot's assumption.

Coordination is important because overall efficiency requires that the generators know the expansion plans of the network; and *vice versa*. If the network planner were simply to ask the generators (sometimes known as 'cheap talk'), it may not get a truthful answer. The generators might see an advantage in over-stating their planned capacity because the expansion of the network that could follow this flow of information will benefit the generators.

The authors note that they are looking at only one side of the issue. While on the one hand, unbundling causes a coordination problem, on the other hand it opens up competition and its attendant benefits. Therefore, the authors 'cannot draw conclusions with regard to the overall effect' of unbundling.

There are thirty nine items in the reference list.

This article can be accessed by subscription to *Competition and Regulation in Network Industries*.

Optimizing Prices for Small-scale Distributed Generation Resources: A Review of Principles and Design Elements, Amparo Nieto, *Electricity Journal*, 29, 3, April 2016, pp. 31-41.

Integrating distributed energy resources (DERs) into the utility's grid has become a major item in US federal and state regulatory agendas as part of the continuing effort to promote cleaner energy resources. The right combination of rate design reforms, regulatory approaches, and organisational structures can lead to an economically-efficient expansion of DER. A primary goal when integrating DER is to ensure that creating opportunities for customer engagement in demand response, small-scale clean Distributed Generation (DG), such as solar photovoltaics (PV) and, in the longer term, behind-the-meter energy storage, takes place without undermining fairness among utility customers. Achieving that goal is unlikely given the prevailing rate structures and net energy metering arrangements. In practice, residential and commercial rates do not signal the value of

distributed solar generation and other DERs to the system.

Amparo Nieto argues that the appropriate rate design is one that is consistent with the underlying structure of marginal costs of providing service. In particular, a multi-part, time-differentiated rate structure will go a long way towards achieving a more economically efficient integration of solar DG in the utility's grid.

The author also discusses in detail alternative pricing mechanisms to net metering that can be adopted to address growing penetration of rooftop solar PV and other DERs, when implementing a strictly marginal-cost based rate structure is not feasible. Finally, she discusses the ability of regulators to effectively maximise reliability gains from DER, beyond those allowed by the current geographically-uniform rates. Such gains are attainable through locational rebates to those DG customers who decide to adopt storage, either individually or as part of a microgrid, and commit to engage in mutually-beneficial interactions with the macrogrid, such as activities that shed area peak load.

This article can be accessed by subscription to *The Electricity Journal*.

Demand Response: Getting the Prices Right, William Hogan, *Public Utilities Fortnightly*, March 2016, pp. 20-23.

This article discusses the legal issue over the Federal Energy Regulatory Commission's (FERC) jurisdictional authority to set demand-response prices. In the case involving the Electric Power Supply Association (EPSA), the Supreme Court found for FERC in support of its demand-response rule (Order 745). The second part of the decision addressed the compensation for demand response, and found that, while it was not arbitrary and capricious, it did not make a finding about the merits of its Locational Marginal Price (LMP) rule. In William Hogan's view, 'FERC made a mistake' and 'should change the rule'.

The author questions the Order 745 demand response compensation mechanism, which calls for paying the Locational Marginal Price (LMP). Instead, he contends that the issue is ensuring the efficiencies of prices in reflecting costs, which is different to minimising price to loads.

The 'negawatt'* demand response can be interpreted as the customer having an option to purchase to satisfy demand with the strike price set at the retail price. Should the buyer exercise the option, it would pay the retail price. If the buyer does not exercise the option and does not consume, it will not pay the

retail price. Therefore, if the strike price of the option is 'G', then the option value is 'LMP-minus-G'.

It is argued that the Order 745 mandate of paying LMP instead of 'LMP-minus-G' creates a double payment problem which can lead to the installation of inefficient generation only profitable on the customer side. William Hogan believes that this is discriminatory and will create expanding opportunities for mischief. The analogy used likens this situation to reselling an item which has not been purchased.

The author notes that whilst the industry and FER are fighting against policies and regulations which distort spot-market prices, the pricing rule in Order 745 institutionalises price manipulation. Since success depends on sending the right signals to market participants to make better investment and operating choices, Order 745 will ultimately prescribe further regulation which will only hamper innovation.

Given the mandate explained by the Court, William Hogan believes that the FERC should change the pricing rule.

(*According to *Whatis.Com*: A negawatt is a negative megawatt: a megawatt of power saved by increasing efficiency or reducing consumption. Physicist Amory Lovins coined the term and introduced it in a speech in 1989. Negawatt started life as a typo: Lovins saw megawatt spelled with an 'n' in a document he was reading and was struck by the potential of that typo as a useful concept.)

This article can be accessed by subscription to *Public Utilities Fortnightly*.

The Disparate Adoption of Price Cap Regulation in the U.S. Telecommunications and Electricity Sectors, David Sappington and Dennis Weisman, *Journal of Regulatory Economics*, 49, 2016, pp. 250-264.

Price cap regulation (PCR) has experienced widespread adoption in the US telecommunications industry, but not in the electricity industry. The authors of this article see this as 'somewhat puzzling' because PCR often is considered to be a superior form of economic regulation quite generally, rather than only a superior form of regulation in selected settings. The authors suggest several possible explanations for the observed disparate experiences.

First, the authors suggest that these disparate experiences may reflect in part the manner in which PCR often is implemented in the US.

Second, it may reflect relatively limited opportunity for 'regulatory bargains' in the electricity industry.

Third, they suggest that there is only relatively limited competition in the transmission and distribution components of the electricity industry.

There are 73 items in the reference list, dating from 1975 to 2016. The most commonly cited journals are the *Journal of Regulatory Economics*, the *RAND Journal of Economics* and the *Review of Network Economics*.

This article can be accessed by subscription to the *Journal of Regulatory Economics*.

Substitution between Fixed-Line and Mobile Access: The Role of Complementarities, Lukasz Grzybowski and Frank Verboven, *Journal of Regulatory Economics*, 49, 2, April 2016, pp. 113-151.

This article examines substitution from fixed-line to mobile voice access, and the role of various complementarities which may slow down this process. The authors use survey data of 160,363 households across 27 EU countries during 2005-2011.

For this study, a traditional discrete choice econometric specification would not be feasible, as it is possible to be subscribed to both a fixed-line and a mobile service. It is also possible that voice services can be combined with Internet technology. To incorporate these effects, a discrete-choice model for bundles of alternatives was specified.

The dependent variables were three bundles – mobile, fixed-line and both. The explanatory variables included price, macro-economic variables, and dummy variables for whether the service was bundled and the year. The logit model was estimated by maximum likelihood. Further models were estimated which investigated the substitution effect in relation to location, marital status, gender and profession. Own-price and cross-price elasticities of fixed-line and mobile networks are estimated.

In order to investigate further the effects of incumbency and internet technologies on the substitution effect of fixed-line and mobile networks, a choice model for the relationship between the dependent variable and various types of internet connections (dial-up, DSL, cable, mobile broadband) was also estimated. The authors noted that complementarity with the internet has been a main driver in slowing down the process of fixed-to-mobile substitution. The model estimated that, without the advent of DSL technology, fixed-line voice penetration would have been 6.3 per cent lower in 2006 and 8.7 per cent lower in 2011.

It was also noted that there might be supply-side factors which could influence the substitution

between fixed-line and mobile networks, such as regulation, the presence of MVNOs and policies regarding infrastructure sharing and termination rates.

The authors concluded that fixed-line connections are in decline because of significant substitution from fixed-line to mobile networks, with mobiles reducing fixed-line network access by 14.1 per cent in 2011. It was emphasised, however, that substitution was not homogenous. For example, it is generally stronger within regions of higher income per capita. Complementarities such as bundled contracts and incumbency advantages were also shown to have an impact on fixed-line and mobile network substitution.

The reference list contains twenty-five items, dating from between 1996 and 2015. Most articles discuss the complementarity and substitutability of fixed-line and mobile networks, with many empirical papers on various international markets, including countries in the European Union and Africa. The most commonly cited journal is *Telecommunications Policy*, followed by the *Journal of Regulatory Economics* and *Economics Letters*.

This article can be accessed by subscription to the *Journal of Regulatory Economics*.

The Welfare Effects of Banning Off-net/On-Net Price Differentials in the Mobile Sector, Christian Rojas, *Telecommunications Policy*, 39, 7, August 2015, pp. 590-607.

This paper contains a consideration of the off-net/on-net price differential in mobile voice service observed in many countries. Christian Rojas argues that the differential is greater than can be 'explained away by standard economic theory'. Regulation has been contemplated in some jurisdictions. The author constructs a model to analyse the welfare effects of such intervention, focusing on the short-run welfare effects. The model is applied to data from Chile, where the competition authority had banned the practice of a differentiated price. The model revealed that, in this particular case, the intervention harmed consumers and benefited carriers, and, under some circumstances, total economic welfare is reduced. Long-run competitive effects are not captured in the model. There are eighteen items in the reference list (fourteen are to the professional literature) with publication dates ranging from 1998 to 2013.

This article can be accessed by subscription to *Telecommunications Policy*.

Three Principles for Optimal Pricing of Trackage Rights, Kenneth D Boyer, *Review of Industrial Organization*, 49, 2, September 2016, pp. 347-369.

This article borrows from the literature on optimal road pricing to suggest three efficiency-based principles for the pricing of railway track access fees.

The first principle is to set track fees as close as possible to optimal congestion tolls on a track segment. This will lead to existing tracks being used optimally in terms of traffic routing and levels.

The second principle is to ensure that track fees are devoted to paying for track maintenance, the opportunity cost of land and the amortisation of plant and equipment installed on that track. By ensuring that each link is financed by the congestion tolls generated on that link, incentives are put in place for track capacity on each link to be optimal.

The third principle is that track fees should be set by traffic and cost conditions on a line, rather than the identity of the user. This will ensure potential users make optimal usage and investment decisions in terms of the railroads they decide to use.

The author suggests that, in long-run equilibrium with constant returns to scale, the optimal congestion toll is equal to the average annual ownership cost of the track segment. Therefore, the optimal track charges can be calculated from financial and accounting records, rather than requiring engineering calculations.

The economic models used in this article were motivated by tracks being used to ship a single commodity, with homogeneity allowing for calculation of average costs. However, even without homogeneity, the principle of charging congestion tolls is still relevant – users should be charged the dollar amount of delays their presence imposes on the entire traffic on a line segment, with different charges based on the different amounts of delays caused.

The author concludes that much more research is necessary in order to move from the current non-optimal pricing system to one that encourages greater economic efficiency.

The reference list contains 27 elements, with articles published in journals such as the *Rand Journal of Economics* and the *Journal of Regulatory Economics*. Several seminal articles are listed, such as Baumol and Bradford's 1970 article 'Optimal Departures from Marginal Cost Pricing' and Vickrey's 1969 article on congestion theory and highway investment (both from the *American Economic Review*).

This article can be accessed by subscription to the *Review of Industrial Organization*.

The Cost of Capital: A Cross-country and Cross-industry Perspective, Alberto Biancardi, Cristina Cifuentes, Isabelle Dechavanne, Annegret Groebel, Fadhel Lakhoua, Stéphane Lhermitte, Catherine L'Hostis and Ian Rowson, Club of Regulators' Workshop, Université Dauphine Paris, 12 April 2016.

This report summarises the presentations of the French and international regulators who contributed to the Club of Regulators' workshop on 12 April 2016. The report is comprised of seven short papers and reports on the roundtable discussions. The short papers are: Introduction (Catherine L'Hostis); The Cost of Capital: A Contrast in Approaches (Cristina Cifuentes); A Comparison of Energy and Telecoms Regulation in Germany (Annegret Groebel); A UK Cross-sectoral Perspective (Ian Rowson); The Cost of Capital in the Energy and Water Sectors in Italy (Alberto Biancardi); The Regulatory Capital Rate of Return (Stéphane Lhermitte); The Cost of Capital: A Cross-country and Cross-industry Perspective (Fadhel Lakhoua); and The Cost of Capital: Arafer's Approach (Isabelle Dechavanne).

Broadly, the report sees that determining the cost of capital is a complex financial, technical and political question, involving conflicting interests and requiring a shared vision of the future and a common understanding of complex rate setting. Regulators must: manage these challenges; provide stakeholders with stability; and enable the users to benefit from new technologies and choices.

Costs and Benefits of Friendly Boards During Mergers and Acquisitions, Breno Schmidt, *Journal of Financial Economics*, 117, March 2015, pp. 424-447.

This paper explores the hypothesis that less independent, more-friendly boards can benefit the shareholders of a company. Since measures of firm value and board characteristics are both endogenous variables, interpreting contemporaneous relationships between these two quantities is difficult. The author proposes to overcome this difficulty by considering mergers, which are complex corporate events requiring board approval, and significantly affecting shareholder wealth.

To proxy the independence of the board, observable social connections between the CEO and outside board members are considered. Generally, the results suggested that, when board directors are more likely to possess valuable information about a merger, higher announcement returns are observed

for bidders with more friendly boards. It was also noted that, when manager discipline was required, social ties have a negative impact on the acquirer's performance.

A total of 6,857 mergers announced between 2000 and 2011 were used, with the bidder, board and deal characteristics being noted. Samples from before 2000 were not considered due to concerns about survivorship bias. Social ties between CEOs and board members were considered in terms of common affiliations to various non-business organisations. The data were gathered from director profiles on BoardEx.

Concerns about bias due to the endogenous nature of both board composition and firm value were noted. In general, the more predictable mergers are, the greater the degree to which boards are able to adjust. This makes relationships between board composition and announcement returns spurious. This issue is addressed by considering the situation of 'serial acquirers', companies which actively pursue a strategy of growth through acquisitions, which therefore mean that future merger opportunities are predictable.

The authors found that, when board directors tend to possess valuable information about the merger, higher announcement returns are observed for bidders with more friendly boards. This demonstrates that friendly boards have a systematic positive effect on firm value, hence, board independence is not always efficient. Rather, the decision of board independence should take into account the trade-off between the need to discipline the CEO and the importance of board advice.

The reference list contains sixty-one items, with articles from the *Journal of Finance*, the *Journal of Financial Economics* and the *Journal of Financial and Quantitative Analysis*. Most cited papers are in the areas of corporate finance and corporate governance, primarily focusing on takeovers and acquisitions.

This article can be accessed by subscription to the *Journal of Financial Economics*.

Regulatory Decisions in Australia and New Zealand

Australia

Australian Competition and Consumer Commission (ACCC)

Communications Sector Market Study – Issues Paper Released

On 5 September 2016 the ACCC released an issues paper seeking feedback from industry and consumers as part of its market study of the communications sector. The paper calls for comment on a range of matters that may affect competition, the efficient operation of markets, and investment incentives over the next five years and beyond. **Submissions are invited until 14 October 2016.** It is expected draft findings will be released for comment in mid-2017, before publishing a final report in late 2017.

Mobile Roaming – ACCC to Consider Declaration

On 5 September 2016 the ACCC commenced an inquiry into whether or not to declare a wholesale domestic mobile roaming service. Access to a roaming service would enable mobile service providers to provide coverage for their customers in areas where they don't have their own network. **The ACCC recognises that mobile coverage is an increasingly important issue in Australia, with a greater impact on those living in regional areas.**

Superfast Broadband Networks Declared

On 29 July 2016 the ACCC announced its decision to regulate access to wholesale superfast broadband services and it declared a five-year 'superfast broadband access service' (SBAS). Read more about the announcement.

NBN Co's Proposed Special Access Undertaking Variation – Feedback Invited

On 20 July 2016 the ACCC published a consultation paper inviting submissions on NBN Co's proposed variation to its Special Access Undertaking. The Special Access Undertaking is a key part of the regulatory framework for governing prices and other terms upon which NBN Co will supply services over the NBN to retailers until 2040. NBN Co lodged a proposed variation to the undertaking with the ACCC on 27 May 2016. The consultation paper describes the main changes NBN Co is seeking to make to the undertaking and outlines other key issues on which

the ACCC is seeking feedback. **Submissions on NBN Co's proposed variation were due 26 August 2016.**

Regulation of Wholesale ADSL Service – Inquiry Commenced

On 4 July 2016 the ACCC commenced a public inquiry into whether the wholesale asymmetrical digital subscriber line (ADSL) service should continue to be regulated. The ACCC first declared access to the wholesale ADSL service in February 2012. **The ACCC is required to review the declaration before it expires in February 2017.**

Australian Competition Tribunal (ACT)

No relevant decisions during this period.

Australian Energy Market Commission (AEMC)

New Annual Monitoring of Electricity Network Regulation – Terms of Reference Published

On 8 September 2016 the Australian Energy Market Commission (AEMC) announced a new annual monitoring report to assess the state of economic regulation for electricity networks in the face of energy market transformation. **Electricity networks are moving away from being one-way delivery systems and becoming managers of multi-directional flows of energy.** The AEMC will publish an Approach Paper as well as its preliminary views for stakeholder comment by 1 December 2016. The annual Monitoring Report will be published by 1 July 2017.

Demand Response Mechanism and Ancillary Services Unbundling Rule Change – Draft Determination

On 1 September 2016 the AEMC released its draft determination on the National Electricity Amendment (Demand Response Mechanism and Ancillary Services Unbundling) rule request, calling for public submissions on its proposal to create a new type of market participant who can do deals with energy users to offer demand response, as a tool to help maintain power system security. **Read about this consultation on a preferred rule to facilitate a more competitive ancillary services market.**

Reform of East Coast Gas Market – Recommended Reforms

On 28 July 2016 the AEMC released a package of 15 key recommended reforms to remove roadblocks to faster and more efficient gas trading and access to

pipeline transportation along the east coast of Australia. **This was the final report of the East Coast Wholesale Gas Market and Pipelines Frameworks Review (Stage 2) to the Council of Australian Governments Energy Council.**

Electricity Rule Maker for the Northern Territory

On 30 June 2016 the AEMC announced that from 1 July 2016 it would become the rule maker in the Northern Territory for parts of the National Electricity Rules, following the Territory's adoption of the National Electricity Law. **Read about this further step towards a national energy framework.**

Australian Energy Regulator (AER)

AusNet Services Revised Regulatory Proposal for its Electricity Transmission Network for 2017-22 Submitted

On 23 September 2016 the AER announced it has received a revised regulatory proposal from AusNet Services, as well as submissions on the AER's July 2016 draft decision from third-party stakeholders. The revised proposal sets out the revenue AusNet Services proposes to collect from electricity consumers through transmission charges for the five year period 2017–22. **Responses to AusNet Services' revised proposal are required by 19 October 2016.**

Roma to Brisbane Pipeline Access Arrangement Revision Proposal for 2017-22

On 1 September 2016 the AER received an access arrangement proposal for the Roma to Brisbane Pipeline (RBP) for the period 1 July 2017 to 30 June 2022. The proposal was submitted by the service provider of the RBP, APT Petroleum Pipelines Pty Limited (APTPPL). The AER will hold a public forum in Brisbane on 5 October 2016 to discuss key issues raised in APTPPL's proposal with stakeholders, and **submissions on this proposal are required by 18 October 2016.**

Victorian Energy Distributors' Tariff Statements Approved

On 24 August 2016 the AER approved tariff structure statements submitted by the Victorian energy distributors, which from 2017 will assist consumers in making better choices about their electricity use. **New demand-based tariffs will be offered for the first time from 2017**, but residential and small business customers who don't take these up will remain on their existing network tariffs.

AER Releases Draft Ring-fencing Guideline

On 15 August 2016 the AER **published a Draft Ring-fencing Guideline** designed to prevent network businesses from shifting costs into their regulated business or taking unfair advantage of their regulated position in the energy market. Submissions on the Draft Guideline were due 28 September 2016. The Guideline is due to be completed before 1 December 2016.

Changes Required to NSW Tariff Structure Statements

On 2 August 2016 the AER announced new tariffs for electricity networks, taking effect in 2017 that will assist consumers in making better choices about their electricity use.

Using the new tariffs, electricity retailers will be able to design offers for customers that best meets their needs and support how they want to use electricity – their solar panels, air conditioners, charge their batteries or electric vehicles.

The draft decision is available on the AER website. The distributors' revised tariff structure statements were due by 4 October 2016. The AER will make a final decision on the tariff structures in February 2017:

- Ausgrid – Tariff structure statement 2015
- Essential Energy – Tariff structure statement 2015
- Endeavour Energy – Tariff structure statement 2015

AER Publishes Retail Energy Market Update for Quarter 3, 2015-16

On Friday 4 July 2016 the AER published **retail energy market performance data for the third quarter of 2015-16.**

National Competition Council (NCC)

Declaration of Shipping Channel Services at the Port of Newcastle

On 14 July 2016 the Port of Newcastle Operations Pty Ltd **applied to the Federal Court of Australia** for review of the Australian Competition Tribunal's decision that shipping channel services at the Port of Newcastle should be declared.

Australian Capital Territory

Independent Competition and Regulatory Commission (ICRC)

Review of Icon Water's Pricing Structure

See 'Notes on interesting Decisions'.

New South Wales

Independent Pricing and Regulatory Tribunal (IPART)

Retail Electricity Market Monitoring 2016

On 20 September 2016 the IPART released a draft report as part of its monitoring of NSW retail electricity prices, following their deregulation on 1 July 2014. The NSW Government has asked IPART to monitor and report annually on competition for small customers in the retail electricity market in NSW. **Read more about IPART's 2015-16 review.**

WaterNSW's Rural Bulk Water Services (formerly State Water Corporation) – Review of Prices to Apply from 1 July 2017

On 13 September 2016 the IPART commenced a review of the maximum prices that WaterNSW can charge for its monopoly bulk water services in rural areas. Prior to 1 January 2015, these services were provided by the former State Water Corporation. **The prices set in this review will apply from 1 July 2017.**

Sydney Desalination Plant – Review of Prices to Apply from 1 July 2017

On 29 August 2016 the IPART ceased accepting submissions concerning its review of the charges associated with the Sydney Desalination Plant Pty Ltd. The desalination plant at Kurnell provides an additional source of drinking water for residents of greater Sydney when dam levels are low. **Prices set in this review will apply from 1 July 2017.**

Northern Territory

Utilities Commission

Draft Access Policy – Port of Darwin: Amended

On 26 July 2016 the Utilities Commission **posted an amended Draft Access Policy** for the Port of Darwin for comment.

Queensland

Queensland Competition Authority (QCA)

See 'Notes on Interesting Decisions'.

South Australia

Essential Services Commission of South Australia (ESCOSA)

Review of the Electricity Transmission Code – Final Decision

On 22 September 2016 the ESCOSA released its final report on the review of the Electricity Transmission Code. The amended Code (designated TC/09) will apply on and from 1 July 2018. **Reasons for the amendments are set out in the final decision paper.**

Strategic Directions – Consultation

On 31 Aug 2016 the ESCOSA announced a forum to be held 14 September at Adelaide Town Hall seeking community, industry and other stakeholder views to help inform its strategic direction for the coming three-year period July 2017 to June 2020. **Read more about the strategic direction consultation.**

Retailer Feed-in Tariff – Review of Regulatory Arrangements Draft Report

On 11 August 2016 the ESCOSA announced it was consulting on a draft proposal to cease setting the minimum Retailer Feed-in Tariff (R-FIT) in South Australia from 1 January 2017. Written submissions were required by 9 September 2016.

Tasmania

Office of the Tasmanian Economic Regulator (OTTER)

Tasmanian Electricity Network Reliability Review – Draft Report

On 7 September 2016 the Tasmanian Economic Regulator released the Draft Report of its 2016

Network Reliability Review for public consultation. **This review was commenced in late 2015 but was deferred as a result of the recent Basslink outage.** Submissions are required by 30 September 2016 with the Final Report anticipated in November 2016.

Victoria

Essential Services Commission (ESC)

Review of Water Pricing Approach – Submissions Received

In July 2016 the ESC published submissions received in response to the May 2016 release of its water pricing position paper titled *A New Model for Pricing Services in Victoria's Water Sector.*

Energy Compliance and Enforcement Policy – Final Decision

On 22 July 2016 the ESC published its Final Decision on the new Energy Compliance and Enforcement Policy, which provides information on the ESC's approach to compliance and enforcement in the Victorian energy market. **The Policy replaces the Interim Approach to Energy Compliance and Enforcement (December 2015).**

True Value Inquiry, Distributed Generation – Discussion Paper Released

On 29 June 2016 the ESC released its Discussion Paper for stage 2 (network value) of the inquiry into the true value of distributed generation. The inquiry involves two stages: looking at the energy value of distributed generation; and examining network value. Submissions were required by 29 July 2016. **The Final Report for network value will be completed in February 2017.**

Western Australia

Economic Regulation Authority (ERA)

Proposal to Transition Operation of the WA Gas Retail Market Scheme from REMCo to AEMO

On 22 September the ERA announced it is seeking public comment on The Retail Energy Market Company (REMCo) rule change proposal 'C02/16C – AEMO Transition' lodged with the ERA on 2 September 2016. The rule change proposal is for transition of responsibility for operation of the Western Australian gas retail market scheme from REMCo to the Australian Energy Market Operator. **Submissions are required by 10 October 2016.**

Mid-West and South-West Gas Distribution Systems Access Arrangement

On 19 July 2016 the Australian Competition Tribunal made its decision on the limited merits review of the ERA's access arrangement decision for the Mid-West and South-West Gas Distribution Systems (GDS), operated by ATCO Gas Australia, upholding the ERA's decision on all grounds of review, apart from the value of imputation credits (γ). **Read more about the natural gas networks.**

New Zealand

New Zealand Commerce Commission (CCNZ)

Spark's Resale Services – Intended Recommendation for Deregulation

See 'Notes on Interesting Decisions'

Fonterra's 2015-16 Base Milk Price Calculation – Final Report

On 15 September 2016 the CCNZ **released its Final Report** on Fonterra's calculation of the base milk price for the 2015-16 dairy season, finding that it is 'largely consistent' with both the efficiency and contestability purposes.

Notes on Interesting Decisions

The Standard User Funding Agreement (SUFA) and Expansion of the Central Queensland Coal Network

The Standard User Funding Agreement (SUFA) stems from the fact that the Queensland Competition Authority (QCA) cannot make an access determination requiring Aurizon Network (AN) to bear the costs of an expansion. Parties wishing to expand the central Queensland coal network have argued that AN may use this position to extract a rate of return above the regulated rate.

The potential for such a position to exist may undermine the objective of Queensland's third-party access regime, which is to promote the economically efficient operation of, use and investment in, significant infrastructure by which services are provided, with the effect of promoting effective competition in upstream and downstream markets.

SUFA is a suite of pro forma agreements to facilitate financing alternatives to AN funding significant rail infrastructure expansions. Through the provision of financing choice for a given expansion, SUFA can provide a credible competitive threat, thereby reducing the ability of AN to seek a rate of return higher than the regulated rate. In the context of the Queensland environment there is no direct regulatory precedent for SUFA.

AN's 2010 Access Undertaking (2010 AU) required AN to provide the QCA with a proposed SUFA and any related amendments to the 2010 AU. AN submitted its 2013 Standard User Funding Agreement Draft Amending Access Undertaking (2013 SUFA DAAU) under the 2010 AU on 23 July 2013. AN's 2013 SUFA DAAU represented a second generation SUFA. AN's initial proposals were withdrawn because they did not provide a credible alternative to AN financing a given infrastructure expansion.

AN's proposed SUFA is based upon a trust model where preference unit holders (PUHs) in a SUFA trust commit the funds required to develop an infrastructure project (the construction phase), in return for unsecured rights to future rental cash flows (the operational phase). AN also proposed that PUHs had to be access holders or related to an access holder.

Under AN's proposals, it was anticipated that primarily large mining companies could fund a SUFA project off-balance-sheet, and that smaller mining companies might lack sufficient funding or reserves to do so. Stakeholders generally considered AN's

overall proposals unlikely to be workable from a practical perspective.

On 14 June 2016 the QCA released its final decision to refuse to approve AN's proposed SUFA.

The amendments proposed in the final decision seek to provide a SUFA framework capable of supporting alternative third-party financing of infrastructure expansions as well as mining companies and train operator financing, thereby maximising financing choice. This has required the development of a set of finely-balanced arrangements that seek to appropriately account for the interests of all relevant stakeholders, which include the state of Queensland and prospective third-party financiers. It has also resulted in the proposed SUFA arrangements within the final decision being quite different to those proposed by AN.

Unless a SUFA framework is capable of attracting third-party financing and thereby offering credible financing choice, SUFA is unlikely to be an effective regulatory tool. Given SUFA represents a new regulatory approach, the final decision is, in part, testing the extent to which the third-party access regime within the QCA Act can support its own objective. If the final decision SUFA framework is not viable, or cannot be amended to be viable, this may suggest there are unforeseen limitations with the third-party access regime in the QCA Act.

Over the coming months this will become clearer. The QCA's final decision regarding AN's proposed SUFA has been made under AN's 2010 access undertaking. This is due to be replaced by a new access undertaking in 2016. A condition of the new undertaking is that AN is required to submit a proposed SUFA that takes into account the QCA's final decision on SUFA. This process is likely to indicate whether SUFA can become an effective regulatory tool, or whether there is merit in reviewing the extent to which the QCA Act encourages efficient investment in significant infrastructure, as per the objective of the third-party access regime.

Information on SUFA is available here on the QCA website. This note is contributed by Sean McComish, Principal Analyst, QCA.

Review of the Pricing Structure for Water and Sewerage in the Australian Capital Territory

On 6 September 2016, the ACT Independent Competition and Regulatory Commission (ICRC) released its draft report into the structure of Icon Water's water and sewerage services tariffs in the ACT. This release is part of the ICRC's review of Icon Water's water and sewerage services tariff structures which commenced with the publication of an issues paper in November 2015; followed by a technical paper released in February 2016 on the

elasticity of demand for water in the ACT; and then a technical paper on marginal cost pricing in the ACT which was published in June 2016.

The draft report is about the structure of Icon Water's prices. The ICRC points out that 'any findings from this review will not lead to any increase or decrease in the average prices paid by ACT residents overall'. The actual review of the revenue that Icon Water is allowed to recover, and any changes to the overall price levels, is expected to commence in 2017 and will come into effect on 1 July 2018.

With respect to water, the current water tariff structure comprises an annual supply charge and a two-tiered usage charge. The first tier charge is \$2.61 per kL for the first 200 kL and \$5.24 per kL for consumption above that level. This structure of prices was introduced during the 'Millennium Drought' and was designed to discourage water usage. The ICRC provides evidence that the supply situation in the ACT now is quite different. Expansion in capacity, primarily to the Cotter Dam, and the breaking of the drought, means that the ACT is now much more water secure. The ICRC claims that modelling water consumption and inflows, adjusted for the impact of climate change, indicates that 'further augmentation to capacity is not likely to be needed for at least another 30 or 40 years'.

An effective tariff structure should allow for the recovery of the efficient cost of providing water services. It should also provide incentives to use water efficiently depending on the supply conditions of the time. In view of these principles, the draft report finds that given the current water supply conditions in the ACT, the existing water tariff structure can be improved. Given current conditions, an efficient price structure would have a single-usage charge based on the operational cost of providing the water and would include the value of the water. The remainder of the costs would be recovered from the supply charge.

The draft report suggests that there should be a 'rebalancing' between the supply charge and the usage charge. Such a change would see a relative increase in bills for low water users and a decrease in bills for higher users compared to their existing bills. The draft report suggests that any change should be phased in over a ten-year period. The nature of the rebalancing would change if the Australian Capital Territory moved into a period of drought or water scarcity, in which situation the usage charge would need to increase relative to the supply charge. This could also occur into the future if the capacity of the water system becomes tighter.

With respect to sewerage services, Icon Water's current tariff structure comprises an annual supply charge for residential premises, and the same supply charge plus an annual charge per flushing fixture (in

excess of two) for non-residential premises. The draft report suggests that, in the absence of a reliable measure of discharge volumes, it is unlikely that any potential economic efficiency benefits of introducing a sewage usage charge will outweigh the costs. The draft report therefore concludes that the current tariff structure should be retained.

The ICRC is seeking submissions from stakeholders on the draft report (closing 30 November 2016). **The draft report and all other review papers are available here.**

Commerce Commission of New Zealand Recommends Deregulating Spark's Wholesale Voice Services

On 23 September 2016 the Commerce Commission of New Zealand (CCNZ) released a report for consultation indicating its intention to recommend to the Minister for Communications that Spark's resale voice services be deregulated.

Schedule 1 of the Telecommunications Act contains the regulated wholesale services. The three wholesale services that are the subject of this review are used by retail service providers (RSPs) to supply the most common retail telecommunications services to end-users. As markets evolve, new retail services are developed and wholesale service providers can face increased competition, to an extent that it may no longer be necessary to mandate access to a service through Schedule 1.

On 30 June 2016 the CCNZ announced it would investigate removing three resale services from Schedule 1 of the Telecommunications Act: local access and calling service offered by means of fixed telecommunications network; retail services offered by means of a fixed telecommunications network; and retail services offered by means of a fixed telecommunications network as part of a bundle of retail services.

Essentially, Spark's resale voice services enable other RSPs (including Chorus, local fibre companies and fixed wireless operators) to 'rebrand' and on-sell fixed-line telephony services based on Spark switches, avoiding the need to deploy their own infrastructure. These services are provided on a commercial basis. The inclusion of these services in the Telecommunications Act gives the Commission the ability to specify terms for the services but this has not been required to date.

The CCNZ informs that broadband networks now cover 97 per cent of commercial and residential landlines and provide competitive alternatives for delivering voice services. The remaining three per cent are mainly remote voice-only customers where Spark is the sole fixed-line wholesale provider. However, for the majority of these remote lines,

RSPs can use fixed-wireless services from either the Rural Broadband Initiative or based on extended mobile networks. A small number of outstanding consumers that can access voice-only lines are protected by a separate regulated price cap. Given this, the CCNZ's view is that resale services should be removed from the Telecommunications Act.

The draft report can be found on the CCNZ's website. Submissions close on Monday 17 October 2016 and cross-submissions close on Wednesday 26 October 2016. A public conference to discuss the CCNZ's view and submissions will be held on 1 November 2016. The CCNZ expects to provide its final recommendation to the Communications Minister in January 2017.

Regulatory News

Commerce Commission of New Zealand (CCNZ) 2017 Conference

The CCNZ will hold its 2017 conference, titled 'Competition Matters 2017' in Wellington on 20 and 21 July 2017. Registration will open in early 2017.

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@acc.gov.au) and for mailing list enquiries please contact Genevieve Pound (Genevieve.Pound@acc.gov.au).