

Overview

Draft Statement of Principles for the Regulation of Transmission Revenues

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Overview of the Draft Statement of Principles for the Regulation of Transmission Revenues

1. Commission's role as regulator of transmission revenues

In a process coordinated through the Council of Australian Governments (COAG), the relevant jurisdictions (New South Wales, Victoria, Queensland, South Australia and the Australian Capital Territory) have created a National Electricity Market (NEM) in southern and eastern Australia. The NEM commenced on 13 December 1998, establishing a single wholesale market for electricity and an access regime for the transmission and distribution networks in participating jurisdictions. The arrangements for the operation of the NEM are set out in the National Electricity Code (NEC).

In general the electricity reforms which culminated in the commencement of the NEM have sought to create an environment where the contestable parts of the industry are exposed to competition in order to improve the efficiency of production and resource allocation, investment decisions and to minimise costs. However, those elements of the electricity industry that are not currently susceptible to competitive pressures, such as elements of transmission and distribution network service provision, are instead subject to regulatory supervision. This regulatory supervision is directed at facilitating competition in upstream and downstream markets, in part through eliminating monopoly rent taking by transmission network service providers/owners (TNSPs).

The Australian Competition and Consumer Commission (the Commission) will assume responsibility for the regulation of transmission revenues in the NEM, on a progressive basis, with effect from 1 July 1999. Consistent regulation of transmission networks according to the provisions of the NEC and the framework set out in the *Statement of Principles for the Regulation of Transmission Revenues (Regulatory Principles)* will occur from 1 January 2003.¹

The NEC envisages that the Commission will develop a set of guidelines outlining how it will exercise its power to regulate transmission revenues. The *Draft Statement of Principles for the Regulation of Transmission Revenues (Draft Regulatory Principles)* is issued in response to this provision of the NEC.

In developing the *Draft Regulatory Principles*, the Commission has drawn heavily upon the principles and objectives outlined in clause 6.2 of the NEC, which are reproduced in Box 1.

¹ The Commission is the regulator of transmission revenues in NSW and ACT from 1 July 1999, and has recently released a draft revenue cap decision: *Draft Decision, NSW and ACT Transmission Network Revenue Caps 1999/00-2003/04*, 12 May 1999. The Commission will take on regulation of Queensland electricity transmission networks from 1 January 2002. The Commission will commence administration of the Victorian Tariff Order and the South Australian Electricity Pricing Order from 1 January 2001. Therefore, it will not be until 1 January 2003 that the Commission will be the regulator of transmission revenues in these jurisdictions according to the provisions of Chapter 6 of the NEC and the framework set out in the *Regulatory Principles*.

Box 1: Objectives and principles of the transmission revenue regulatory regime

The NEC establishes that:

1. the transmission pricing regulatory regime must achieve outcomes which:
 - a) are efficient and cost effective;
 - b) are incentive based, including the sharing of efficiency gains between network users and owners as well as the provision of a reasonable rate of return (without monopoly rents) to network owners;
 - c) foster efficient investment, operation, maintenance and use of network assets;
 - d) recognise pre-existing government policies on asset values, revenue paths and prices;
 - e) promote competition; and
 - f) are reasonably accountable, transparent and consistent over time;
2. the regulation of aggregate revenue of transmission networks must:
 - a) be consistent with the regulatory objectives (see 1 above);
 - b) address monopoly pricing concerns, wherever possible, through the competitive supply of network services but otherwise through a revenue cap;
 - c) promote efficiency gains and a reasonable balance between supply and demand side options;
 - d) promote a reasonable rate of return to network owners on an efficient asset base where:
 - i) the value of new assets are consistent with take-or-pay contracts or NEMMCO augmentation determinations;
 - ii) the value of existing assets are determined by jurisdictional regulators and must be lower than their deprival value; and
 - iii) any asset revaluations undertaken by the Commission are consistent with COAG decisions;
3. the form of the economic regulation shall:
 - a) be a revenue cap with a CPI-X incentive mechanism, or some other incentive based variant, for each network owner;
 - b) have a regulatory control period of at least five years;
 - c) take into account expected demand growth, service standards, weighted average cost of capital, potential efficiency gains, a fair and reasonable risk adjusted return on efficient investment and ongoing commercial viability of the transmission industry; and
 - d) only apply to those assets the Commission does not expect to be offered on a contestable basis;
4. the TNSPs must provide the Commission with annual financial statements, and other information as required, so the Commission can monitor compliance with the revenue cap and assess cost allocation.

Source: National Electricity Code, Version 1.0, 1998, clauses 6.2.2 – 6.2.5.

In formulating the *Draft Regulatory Principles*, the Commission has also been directed by the following principles of best practice regulation. The Commission believes that:

- effective communication and consultation should take place between the regulator and all stakeholders, so as to encourage transparent decision making processes;
- the regulatory process should be predictable, so regulated businesses can feel confident that consistent, well defined decision making criteria will be adopted by the regulator;
- the regulatory process should be flexible, to allow for the regulatory approach to evolve over time in response to new developments and innovations; and

- as the regulatory regime should be effective and efficient, it will need to assess the cost effectiveness of the proposed regime and alternative regulatory options.

As the regulator of transmission revenues the Commission is committed to consistency in its decision making across and within industries, unless there are compelling arguments for pursuing different approaches. The Commission, however, recognises that tradeoffs may need to be made between providing regulatory certainty and working with the flexibility required to deliver the best regulatory outcomes. The Commission will need to balance the interests of customers and investors, service standards and price, and the need to provide incentives for long term efficient investment and the desirability of setting prices which track efficient costs as closely as possible.

The Commission is also conscious of the need to develop a consistent national regulatory framework. Important sources that have guided the Commission in its preparation of the *Draft Regulatory Principles* include its experience in the electricity, gas and telecommunications industries. The *Draft Regulatory Principles* also takes into consideration submissions from interested parties made in response to the *Regulation of Transmission Revenues Issues Paper*, May 1998.

The *Draft Regulatory Principles* indicate to interested parties the Commission's position on the issues to be addressed in the regulatory process. The *Draft Regulatory Principles* are statements of the Commission's intent with regard to regulation of each TNSP's revenue cap, as required by the NEC. The *Regulatory Principles* are not intended to be legally binding and it must be accepted that, in line with achieving best practice regulation, the Commission's position on some issues is not final. Further, as other regulators develop and implement alternative regulatory models, both in Australia and overseas, the Commission may choose to modify its approach. Moreover, it is envisaged that the *Regulatory Principles* will continue to evolve in response to improvements in regulatory models worldwide.

Changes to the *Regulatory Principles*, however, will not be implemented without undertaking a public consultation process.

2. Form of transmission revenue regulation

The NEC outlines the general principles and objectives for the transmission revenue regulatory regime to be applied by the Commission. It also allows the Commission the flexibility to use alternate methodologies, providing they are consistent with the NEC's 'objectives, principles, broad forms and mechanisms, and information disclosure requirements'. For example, the NEC requires the Commission to set a revenue cap for TNSPs, that is to determine the maximum allowable revenue (MAR) they can earn. However, if the Commission considers that there is sufficient competition to warrant a more light handed regulatory approach it may determine and apply such an approach.

In assuming its role as the national regulator of transmission revenue in the NEM, the Commission's aim is to adopt a regulatory process which eliminates monopoly pricing, provides a fair return to network owners, and creates incentives for managers to pursue ongoing efficiency gains through cost reductions. In achieving these aims the Commission is aware of the need to ensure compliance costs are minimised and that the regulatory process is objective, transparent and as light handed as possible.

In setting up a framework for transmission revenue regulation the Commission has been acutely conscious of the deficiencies of existing regimes. In its Final Decision on the Victorian Gas Access Arrangements, the Commission made a commitment to address the issues of concern raised in the context of that decision within the *Draft Regulatory Principles*.² The Commission has therefore used the *Draft Regulatory Principles* as an opportunity to propose a regulatory framework which, while building on the experience of existing regimes, avoids some of the major regulatory problems associated with those regimes.

The transmission regulation framework outlined in the *Draft Regulatory Principles* is an accrual building block approach based on forecasts of the cost of service over the regulatory period. The building block approach calculates the MAR as the sum of the return on capital, the return of capital, and operating and maintenance expenditure, that is:

$$\text{MAR} = \text{return on capital} + \text{return of capital} + \text{O\&M}$$

$$\text{MAR} = (\text{WACC} * \text{WDV}) + \text{D} + \text{O\&M}$$

where WACC = weighted average cost of capital;

WDV = written down (depreciated) value of the asset base;

D = depreciation allowance; and

O&M = operating and maintenance expenditure (including administrative costs).

While the assessment of operating and maintenance expenditures is relatively straight forward, assessment of the other elements is not. Determining these elements of the accrual building block raises significant issues with respect to providing TNSPs with a fair and reasonable return while at the same time promoting economic efficiency and an objective, transparent regulatory process.

Each of these elements of the accrual building block and the issues that it raises are discussed in the sections below. The regulatory framework adopted is studied in greater detail in Chapters 3-7 of the *Draft Regulatory Principles*. This overview also discusses the position the Commission has adopted in the *Draft Regulatory Principles* on other elements important to the regulatory process, such as service standards, information requirements, the regulatory period, the treatment of new interconnectors, and ring fencing.

3. Asset valuation

Under the building block approach, the value of fixed assets is fundamental to the calculation of the allowance for both the return on capital and return of capital and will flow directly through to the MAR and therefore transmission network prices.

While there is a wide range of asset valuation methodologies, there is no single approach that is appropriate in all circumstances. It is also true that questions of equity connected with the past pricing of services to users can also be important considerations. Such issues were thoroughly discussed in connection with the Victorian Gas Access Arrangements Decision.

² ACCC, 1998, *Final Decision, Victorian Gas Access Arrangements*, October, Appendix E. Copies of this report are available from the Commission's website: <http://www.accc.gov.au> (under gas).

Except for asset values set for the first regulatory review, the NEC provides that existing and new assets can be revalued, on a basis to be determined by the Commission. Nevertheless, the Commission does not have unlimited discretion in choosing an asset valuation methodology, as the NEC requires the Commission to give consideration to the Optimised Deprival Value (ODV) methodology.³ In the *Draft Regulatory Principles* the Commission considers that given the circularity that would be associated with any deprival value assessment, a depreciated optimised replacement cost (DORC) valuation should be adopted for any initial valuation. The DORC of a network is the sum of the depreciated cost of assets that would be used if the system were notionally reconfigured so as to minimise the forward looking costs of service delivery.

In the *Draft Regulatory Principles*, the Commission has adopted the DORC valuation methodology as the approach it will use to set the *cap* on the valuation of the asset base. The Commission considers that a well defined DORC approach has some significant advantages as a valuation methodology on economic efficiency grounds.

First, regulators often look to competitive or contestable markets for guidance on efficient decision rules for regulating natural monopoly markets. Such comparisons can provide a number of guiding principles for a range of complex regulatory problems.

Second, the maintenance of revenue streams over time at a level that is consistent with a DORC asset valuation will minimise the likelihood of significant shocks to tariffs as the replacement of assets becomes necessary. As the existing assets will dominate the capital base and therefore tariffs for a number of years, this objective of minimising shocks to tariffs can only be achieved if the existing assets are valued at or close to DORC.

Thirdly, any value that is in excess of DORC is likely to imply pricing of services that will expose the service provider to being by-passed. While the significant entry and exit costs that characterise electricity transmission make large-scale duplication of the existing system unlikely, by-pass may be feasible at the edges of the network. In such circumstances, some of the cost that gave rise to the by-pass will inevitably be absorbed by the remaining customers who do not have by-pass options.

The Commission will undertake DORC valuations in a consistent manner. To this end, the Commission will be releasing a guideline on its approach to DORC valuations before the end of 2002.

Given that the NEC requires the Commission to consider ODV, service providers will be given the opportunity to identify at the start of each regulatory review those assets that are subject to by-pass risk and to nominate a more appropriate asset base valuation. If a DORC is performed and assets are stranded, they will be optimized out of the regulatory asset base without any return of investment to the network. However, assets that have been identified by the service provider as at risk of by-pass will be subject to accelerated depreciation prior to removal from the regulated asset base. The Commission may also write down part of the transmission system below DORC in recognition of evidence suggesting that the regulatory asset base valuation currently exceeds the ODV of the system.

³ Clause 6.2.3(d)(4)(iv) of the NEC states that the Commission must have regard to the agreement of the Council of Australian Governments of 19 August 1994, that deprival value should be the preferred approach to valuing network assets.

Concerning asset base roll forward, the approach adopted in the *Draft Regulatory Principles* provides that only capital expenditures deemed to be prudent may be added to the regulatory asset base. Clearly if the full amount of the investment is not required and is not prudent, the regulator should not add the full cost to the regulatory asset base. Where additional capability/capacity is included to allow for demand growth, some overbuilding may be considered prudent given the quantum nature of expansion and scope for economies of scale. Where there is doubt that any overbuilding is prudent, a lesser amount will be added to the regulatory asset base corresponding to what would be considered clearly identifiable demand (including a margin sufficient to satisfy normal redundancy or safety requirements). In most cases, the bulk of expenditures will be included because economies of scale would mean that a smaller capacity addition to infrastructure would be at a higher unit cost. This approach parallels that outlined in the National Gas Access Code.

Additions to the regulatory asset base will be timed to occur when the asset becomes operational. However, where construction times are protracted, the amount added to the regulatory asset base may be increased by an amount equivalent to the return that would be achieved on funds employed during construction.

4. Determining a fair rate of return on the asset base

In determining a rate of return, the NEC specifically requires the Commission to consider the weighted average cost of capital (WACC) for each transmission network. In the *Draft Regulatory Principles*, the Commission has adopted a nominal post-tax WACC approach. The WACC is the weighted average of the cost of equity and the cost of debt, each cost weighted by its proportion in the company's financial structure. The WACC is set on the basis of financial market benchmarks, taking into account the level of commercial risk involved in establishing the transmission infrastructure.

The WACC is a commonly used method for determining a return on an asset base. Its adoption, along with the building block approach, was strongly endorsed in submissions received in response to the *Regulation of Transmission Revenues Issues Paper*. The building block approach combines a rate of return with a regulatory asset value. Given the capital intensive nature of electricity network businesses, the return on capital component of the regulated revenue could account for 50 per cent or more of annual aggregate revenue. As relatively small changes to the rate of return can have a significant impact on the total revenue requirement and ultimately end user prices, it is important that the regulator sets the rate of return at a level which reflects a commercial return for the regulated businesses. Setting a rate of return below the cost of funds in the market could make continued investment in developing the network difficult or unattractive for the owner. This would create pressure for the regulated business to reduce maintenance and capital expenditure below optimum levels and undermine the quality of service offered to users. Conversely if the rate of return were set too high by the regulator, the regulated businesses would earn a return in excess of their cost of capital. This would distort price signals to consumers and investors, resulting in a misallocation of resources and sub-optimal economic outcomes.

Chapter 6 of the *Draft Regulatory Principles* sets out the approach that the Commission will use in determining the WACC. Many aspects of the WACC analysis are complex and contentious, as evidenced by the extensive debate encountered during the Commission's and the Office of the Regulator General's assessment of the Victorian Gas Access Arrangements.

At that time, the use of a pre-tax rate of return was advocated by many parties on the grounds that it avoids the need to explicitly add into the 'cost of service' calculation an amount to compensate for tax obligations of the service provider. The Commission believes that such arguments are misguided in that the tax calculation still needs to be carried out in order to convert from the post-tax rate of return indicated by CAPM benchmarks to the corresponding pre-tax real rate required for the regulatory framework.

Since both pre-tax and post-tax approaches require tax liabilities to be assessed, the primary issue is how best to account for tax liabilities. There are two options – on a short term (period by period) basis or a long term basis. The Commission considers that there are significant flaws associated with a long term assessment of tax liabilities, including:

- the difficulty in calculating a long term effective tax rate. Errors of judgement in estimating the long term effective tax rate can lead to over or under compensation in the rate of return and create perceptions of risk;
- the fact that the WACC will be expressed in nominal post-tax terms, meaning that it will need to be converted to come up with pre-tax real figures. In a pre-tax real framework the conversion formula is complex, as no analytical formula exists to cover all TNSPs. Conversion is not conducive to a transparent regulatory framework; and
- the S-bend problem. Regulated businesses will receive cash advances before their actual tax liabilities eventuate, thus being over-rewarded in the early years but under-rewarded later on. Therefore, the regulated entity will not always receive the rate of return set by the regulator. This may lead to 'gold-plating' in early years and under investment later on.

Given the deficiencies associated with a long term assessment of tax liabilities, the Commission believes that tax liabilities should be assessed on a period by period basis. In so doing, transparency is achieved by adopting a post-tax approach.

A post-tax approach eliminates the need to consider conversion from a pre-tax approach as taxes are passed through in the cash flows. In the United States, this treatment of tax is no longer a controversial issue. Similarly in the United Kingdom, Ofwat, Oftel and Orr use a post-tax approach, while Offer has indicated a preference for the post-tax approach.⁴ The use of a post-tax approach was also supported by experts in the field that the Commission consulted, including Professors Bob Officer and Kevin Davis and Dr Neville Hathaway.

This leaves a choice between whether the cash flow analysis should be completed in real or nominal terms. Although it can be proven mathematically that nominal and real frameworks based on a CPI-X framework are equivalent, the Commission is of the view that the nominal framework has some significant advantages that warrant its adoption.⁵ The *Draft Regulatory*

⁴ Ofwat is the Office of Water Services; Oftel is the Office of Telecommunications; Orr is the Office of the Rail Regulation; and Offer is the Office of Electricity Regulation.

⁵ A CPI-X regime is one where the TNSP is guaranteed inflation protection, so that the risks associated with inflation are passed onto users.

Principles propose the use of a nominal framework at this time because of two major advantages associated with its adoption.

First, a nominal rate of return is better understood by financial markets. A nominal WACC can be directly compared with other financial benchmarks such as interest rates, and the nominal return on equity – irrespective of the inflationary environment. Financial markets typically express earnings and rates of return in nominal (post-tax) terms. Using a nominal post-tax rate of return therefore eliminates uncertainty over the meaning of what rate of return the Commission has provided.

Second, depreciation in a nominal framework is transparent and there is no confusion regarding the extent of recovery. In a nominal framework accumulated depreciation allowances equate to the change in the regulatory asset base valuation over time. This is not the case for a real framework, where depreciation allowances include adjustments for inflation, so that in numerical terms accumulated depreciation may substantially exceed the actual cost of the asset. This creates difficulties in explaining to non-economists that TNSPs are not recovering well in excess of their original infrastructure costs.

5. Return of capital

The objective of encouraging continuing investment in privately owned natural monopoly industries will require investors to be provided with an assurance that they will earn a reasonable (risk adjusted) return on their investment capital, as well as the return of capital provided the market continues to value the services produced with that capital.

The building block approach for determining the MAR for TNSP's includes an allowance for depreciation. Such an allowance recognises the need to recoup the outlay involved in the purchase of the asset, over its useful life. Under the building block approach total revenue earned from the regulated assets consists of the depreciation charge and the allowed return on assets.

Traditional linear depreciation schedules, whether applied in a nominal or a real framework, do not always provide a suitable revenue profile. The key problem associated with the use of linear depreciation profiles is that there is typically a jump in tariffs/revenues when a major asset reaches the end of its useful life and is replaced by another.

The Commission therefore proposes a *competitive depreciation* profile in the *Draft Regulatory Principles*. The *Draft Regulatory Principles* sets out how the competitive depreciation approach is to be applied.

There are two aspects to the proposed depreciation profile:

- the smoothing of revenue paths (via the competitive depreciation approach) designed to avoid inter-generational pricing disparities; and
- adjustments to reflect the impact of future potential stranding of identified assets (i.e. possible redundant assets).

The Commission considers it important to adopt this approach, given that substantial transmission system augmentations are expected in a number of jurisdictions in the next few years.

The proposed approach allows the TNSP to identify assets that are subject to by-pass risk, and voluntarily write down its asset base at a faster than normal rate. In the event that such write down does not occur and the asset base is optimised, then those assets will be removed from the asset base with the service provider losing both the return of and return on capital.

The approach links the long term depreciation profile to a measure of the rate of technological change. The revenue smoothing minimises inter-temporal price distortions (inter-generation price shocks). It also minimises potential geographical price distortions linked to the vintage of assets serving neighbouring systems. Further, it will maintain the consistency requirements of any framework; that is, there will be no double counting of depreciation. Under a nominal approach this means that the accumulated depreciation should not exceed the change in the valuation of the assets over time.

6. Benefit sharing

The Commission appreciates that the form of regulation used and the incentives it creates will have a major impact on market outcomes. The regulatory regime adopted should ensure that efficiency gains are passed on to final consumers, while providing effective incentives to the service provider to maximise efficiency.

With the ability to retain cost reductions as profits, the Commission considers that the service provider has a strong incentive to be more efficient in the provision of network services. However, effective natural monopoly regulation involves not only providing positive incentives for improved efficiency but also ensuring there is sufficient disincentive to avoid inefficiency and poor quality service. These incentives can be achieved by offering financial rewards for improvements in long term cost efficiency above those determined by the regulator, and penalising, through reduced profits or losses, failure to achieve service standards and benchmark efficiency improvements.

If the TNSP can achieve efficiencies greater than those allowed for in the X factor it retains the higher level of profits. In other words the benefits of efficiency gains are shared between the consumer (those gains achieved up to the X factor) and the TNSP (the gains achieved in excess of the X factor). The strength of the incentive effect will be determined in part by both the level of the X factor and the type and timing of sharing arrangements that the regulator puts in place.

Consistent with the broad approach of other Australian regulators and in accordance with NEC requirements, the Commission has adopted a CPI-X approach in the *Draft Regulatory Principles*. Under this arrangement the revenue cap set for each regulated TNSP will increase each year in line with general price increases (as measured by CPI) but decrease each year by the X factor, as determined by the Commission. The Commission also wishes to increase the magnitude of the incentive that the TNSP has to introduce cost savings and for this reason it proposes a form of glide path to enhance the pursuit of efficiencies.

The Commission has decided to implement a glide path for one regulatory period beyond the regulatory period in which the efficiency gains accrued. This form of glide path allows for the gradual sharing of the benefits of efficiency gains between users and the TNSP in the

form of lower prices. However, not all components of the building block will be glide pathed. Where no additional benefit is considered justified there will be an immediate readjustment of costs at the beginning of the next regulatory period – a so called P_0 adjustment. The Commission will make the following adjustments to the components of the building block at the end of each regulatory period, to apply in the next regulatory period:

- rate of return – full P_0 adjustment;
- operations and maintenance expenditure – straight line glide path for the next regulatory period; and
- capital expenditure – full P_0 adjustment.

The Commission has decided not to glide path capital expenditure because it believes that to do so creates a perverse incentive for the TNSP to systematically over-forecast capital expenditures. However, the *Regulatory Principles* do allow for a TNSP to make a case to the Commission that it has implemented efficiencies that justify glide pathing of capital expenditures. Where it is clearly demonstrated by the TNSP that capital expenditure shortfalls are the result of management efficiencies or innovation, the capital expenditure efficiency gains may be subject to a glide path.

7. Service standards

Under a CPI-X revenue cap regulatory approach, there is a risk that a monopoly TNSP may try to reduce costs and hence increase profits by reducing the quality of services offered. Quality of service monitoring by a regulator, assisted by penalties for non-performance, can ensure that TNSPs maintain service quality. The Commission believes that effective incentive-based regulation should include an explicit level of service, for which the TNSP has been provided by the regulator sufficient income to maintain the assets necessary to provide that level of service.

Consequently in the *Draft Regulatory Principles*, the Commission requires TNSPs to propose a single set of service standards, and proposed benchmarks for each standard, as part of their regulatory review application. The Commission will review the TNSP's application and establish a set of service standards with performance benchmarks, and a quality of service monitoring program for each TNSP under its jurisdiction. The Commission will include the resulting set of service standards and benchmark levels of performance in the *Draft Decision* and *Final Decision* on the TNSP's application. The Commission will also publish annual statistics comparing the operating performance of TNSPs it regulates. To achieve this, the Commission will require the data outlined in Annex 8.1 of the *Draft Regulatory Principles* to be collected.

Penalties for non-performance of service standards will be developed and will be imposed during a regulatory review for a TNSP that does not, in the opinion of the Commission, maintain its service to customers at the benchmark level.

8. Information requirements

The Commission is conscious of the information asymmetry problem that it will face in both determining the revenue cap and monitoring the performance of the regulated TNSPs. The TNSPs will always have more information than the Commission about their businesses, their

costs, their capacity to make efficiency improvements and their future market prospects. This problem has the clear potential to distort regulatory outcomes.

Clauses 6.2.5 (a) and (c) of the NEC require TNSPs and/or owners to submit to the Commission certified annual financial statements (in a form to be determined by the Commission) and any other information the Commission reasonably requires to perform its regulatory functions.

The information that the Commission believes that it requires to efficiently regulate TNSPs is outlined in Chapter 10 of the *Draft Regulatory Principles* and in Appendices 1-5. The Commission's objective in using its information gathering powers will be to gain a true and accurate reflection of the financial operations of the TNSP, in order to determine and monitor compliance with a revenue cap. The Commission is concerned that if incomplete, and/or misleading information is used in the determination of a revenue cap, regulatory outcomes may be inappropriate.

The Commission is, however, also aware of the costs of complying with information requests. There is a need, therefore, to balance information requests, ensuring that relevant and accurate information is supplied, without excessive or unnecessary detail. The Commission believes that by adopting the principles of best practice regulation, a regulator can foster a co-operative environment, with well informed participants, and in doing so reduce the overall regulatory costs, without increasing the risks of information asymmetry.

It is true that initially there are significant information requirements for the TNSP in applying this regulatory regime. Regardless of the regulatory approach adopted, the Commission understands that some will see the approach as heavy handed. However, it is important that the Commission has the ability to regulate transmission networks effectively, because as natural monopolies the operation of these networks impact on the wider community. It is also important to note that once certain regulatory parameters have been determined, they will not have to be constantly revisited. It is therefore possible that information requirements will not be so intensive for TNSPs in the future.

9. Regulatory period

The regulatory period refers to the length of time between regulatory reviews and is integral to the effectiveness of incentive based regulation. The length of the regulatory period will impact on the incentives facing the regulated TNSP, and the predicability and stability of the regulatory environment. Clause 6.2.4(b) of the NEC specifies that the regulatory period must be at least five years.

The appropriateness of five yearly reviews depends upon a number of factors such as the rate of technological change, and likely changes in the industry structure and growth rates. Given that the electricity transmission industry is not operating in a static environment, the Commission has argued that the five yearly review period provides a compromise between providing regulatory certainty and stability to TNSPs and also enabling consumers to share the benefits of efficiency gains within a relatively short period of time.

However, the Commission is also of the view in the *Draft Regulatory Principles* that in the future it may be appropriate to extend the length of time between regulatory reviews in some cases. Factors to be considered may include the expected growth of the transmission network under review and the likelihood and expected size of future efficiency gains.

The Commission will consider extending the regulatory review period when requested to do so by the TNSP. In its proposal the TNSP must justify extending the regulatory review period beyond five years, and demonstrate that any such change will not disadvantage users of network services and consumers. The Commission will then consider the merits of the application and address the issue of the length of the regulatory period as part of its revenue cap decision.

A related issue concerns the risk of within period regulatory review (or regulatory recontracting) and the impact this will have on regulated TNSPs facing an incentive based regulatory regime. Implementing within period reviews would lead to increased regulatory risk and could conflict with the principle of regulatory predicability. The Commission proposes that regulatory recontracting should only occur where the benefits of such intervention outweigh its costs. The Commission considers that in general the trigger for initiating a within period review should come from the regulated TNSP affected, but will reserve the right to initiate a review, where the information provided to the Commission is found to have been false or misleading, a material error was made in the regulatory decision, or there is a change of ownership and this may materially change the revenue requirement.

10. The treatment of new interconnectors

Clause 6.2.3(c) of the NEC provides the Commission with the flexibility to determine whether sufficient competition exists to warrant the application of a more ‘light handed’ regulatory approach than revenue capping, and if so, the form of that regulation.

The Commission has formed the view that a light handed regulatory approach may be applied to the regulation of new interconnectors in the NEM. It will allow the MAR for new interconnectors to be determined through a competitive tender process. The Commission considers that an approach whereby the MAR for new interconnectors is determined through a competitive tender process has the potential to enforce some market discipline to the regulation of a new interconnector.

Chapter 12 of the *Draft Regulatory Principles* largely outlines the conditions and process under which the Commission will be willing to allow a competitive tender process determine the MAR for a new interconnector in the NEM. The competitive tender arrangements outlined in this Chapter are similar to those in the National Gas Access Code. The Commission is keen to ensure that the light handed approach, if permitted, delivers acceptable network pricing outcomes. Therefore, the Commission must be satisfied that the number and character of tenders likely to be received would be such as to ensure a competitive outcome. It will also need to be satisfied that the selection criteria applied in conducting the tender process will ensure that the successful tender will be selected primarily on the basis that the tender will deliver the lowest MAR and will result in allocation of costs between users that is fair and reasonable.

11. Ring fencing arrangements

Part G of the NEC requires the Commission to develop ring fencing guidelines for the accounting and functional separation of the provision of prescribed services from the

provision of other services by the TNSP.⁶ The NEC states that the transmission ring fencing guidelines may include, but are not limited to:

- provisions defining the need for and the extent of legal separation;
- establishment and maintenance of consolidated and separate accounts for prescribed services and other services provided by the TNSP;
- allocation of costs between prescribed services and other services;
- limitations on the flow of information between the TNSP and other persons;
- limitations on the flow of information between the TNSP and other persons where there is the potential for a competitive disadvantage; and
- provisions allowing the Commission to add to or waive a TNSP's obligations.

In developing the ring fencing guidelines in the *Draft Regulatory Principles* the Commission's objective has been to attempt to reinforce the effectiveness of the regulatory processes by limiting the ability of the transmission networks to extend their monopoly powers from the network business into the contestable parts of the industry. In particular, the Commission is seeking to ensure that regulated activities do not cross-subsidise contestable activities and that information flows between regulated and contestable activities are appropriately restricted.

The Commission recognises that the electricity industry has undergone structural reform that has reduced the likelihood that regulated activities could be used to subsidise contestable activities. However, it is possible that the networks of the future will grow into businesses quite unlike the electricity networks of the past and will provide a range of contestable services.

Therefore, the possibility exists for incidental and/or related work to be subsidised by expensing such items against regulated components of the business, while recording income as unregulated revenues, not subject to the revenue cap.

Ring fencing arrangements have been developed with varying degrees of success in the context of other monopoly industries. Most recently ring fencing arrangements were developed by the National Gas Reform Task Force and included in the National Gas Access Code. In summary, the National Gas Access Code's ring fencing arrangements establish a number of minimum obligations, provide the regulator with the ability to waive certain obligations, and establish a mechanism for the regulator to impose additional obligations.

The Commission proposes to adopt a set of ring fencing arrangements for electricity transmission networks which are based on the National Gas Access Code's ring fencing arrangements. The majority of interested parties were supportive of the development of ring fencing guidelines along the lines of those in the National Gas Access Code.

In addition the Commission has selected a set of arrangements that provide the flexibility for the Commission to waive the ring fencing arrangements where the costs of compliance outweigh any apparent benefit from imposing the ring fencing provisions. The arrangements

⁶ Prescribed services are defined by the NEC as transmission services provided by transmission network assets or associated connection assets which are determined by the regulator as not being contestable.

also provide for additional ring fencing provisions to be applied where the benefit outweighs the costs.

12. Consultation prior to finalising the Regulatory Principles

One of the Commission's objectives in publishing the *Draft Regulatory Principles* is to provide an opportunity for transmission customers, TNSPs and other stakeholders to participate in the development of the regulatory framework.

The *Draft Regulatory Principles* present to interested parties the Commission's position on the issues to be addressed in the regulatory process and describe the processes by which the Commission will undertake its regulatory task. Interested parties are invited to respond to the *Draft Regulatory Principles* before 30 July 1999. Submissions can be sent to:

The Senior Assistant Commissioner
Electricity Group
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602
Phone: (02) 6243 1249 Fax: (02) 6243 1260

Each submission should clearly indicate a contact person and contact details. If the submission is more than five pages, please include an Executive Summary highlighting the issues being commented upon in the submission.

The Commission requests that five hard copies of each submission be provided and also supplied in electronic format compatible with Microsoft Word 97 for Windows. Copies can be e-mailed to the following address:

electricity.group@acc.gov.au

The Commission will treat all submissions as public unless otherwise indicated.

Copies of all submissions will be placed upon the Commission's public register relating to this matter, and this register can be perused at Commission offices.

The Commission will also hold public information sessions, to present key aspects of the regulatory framework as follows:

Brisbane: Tuesday 15 June 1999
Melbourne: Wednesday 16 June 1999
Sydney: Thursday 17 June 1999

The Melbourne information session will also provide a video link to Adelaide.

Details regarding the times and venues can be obtained from Ms. Maxine Helmling. Interested parties must register to attend an information session by contacting Ms. Helmling on (02) 6243 1246, before Thursday 10 June 1999.

The Commission may also hold a public forum to discuss its position as described in the *Draft Regulatory Principles*. If required, details of the public forum will be placed on the Commission's website.

The Commission will consider the issues raised at the public information sessions, the public forum and in any submissions received and publish its final *Regulatory Principles* later in the year.