

**SUBMISSION TO THE GOVERNMENT
ON THE ESSENTIAL SERVICES COMMISSION**

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Summary

The review into the proposal for an Essential Services Commission is timely in view of the Office of the Regulator-General's (ORG) recent completion of the price re-set for the electricity distribution businesses. IPA's Submission focuses on the price re-set which has, quite properly, dominated the work of the ORG over the past two years.

The Electricity Distribution Price Determination

Share market transactions offer a "reality check" on regulators' decisions. Though the evidence is not clear-cut, the Powercor sale, which took place after the ORG's draft determination in May 2000, offers the best guide. Press reports indicate Powercor sold at a premium of 7% on its 1995 privatisation price. However, that outcome must be considered in the light of Powercor having been well-managed over the five years and its value might therefore have been expected to increase in line with that of the ASX All Ordinaries (45%). Indeed, such an outcome would probably be regarded as conservative, since:

- the business has been a successful retailer in the National Market;
- it won a lawsuit with a NSW generator shortly after its sale, an outcome thought to be worth about \$300 million (with the settlement factored into the price).

The Electricity Price Setting Approach

An equally important outcome from the re-set stems from its adoption of profit control rather than the incentive based CPI-X price control which was originally intended. Unless rectified quickly, this will at best smother the incentives to pursue efficiency.

The process has also brought an unparalleled increase in the paperburden placed on businesses. Over 200 papers were produced, many of them running to hundreds of pages and requiring detailed analysis in their preparation. This has required the creation of well-resourced regulatory functions within each of the businesses. These and the resources required by the ORG itself need to be financed by consumers.

More simplified, automatic and transparent procedures need to be developed if the industry is not to be strangled in red tape and if it is to focus on profitably improving consumer satisfaction rather than meeting the needs of a regulatory agency. If an efficient industry is to be encouraged, the present re-set must be taken as the foundation for future more predictable and less intrusive resets based on economy- or sector-wide productivity achievements.

In addition, Australian regulators, though affirming that competition is the best regulator, have been most reluctant to retract from their positions of control even when competition is evident. The ESC Review presents an opportunity to re-affirm the need for the regulatory agency to remain focussed on areas of natural monopoly. It should offer guidelines that require the regulator to cease regulating where there is evidence of meaningful actual competition in the regulated product or clear evidence of it being contestable.

Structural Issues Regarding the Essential Services Commission

IPA is not attracted to a multi-membered commission. The composition of such commissions tends to reflect government patronage, which detracts from the best appointments. Moreover commissioners are likely to be appointed because they represent some stakeholder body (consumers, suppliers, etc.) resulting in negotiated outcomes rather than those based on achieving greatest efficiency.

Similarly, we are not attracted to outside bodies being appointed to “represent” consumers. Typically such representative bodies or individuals come to comprise political activists and serve parties other than the consumer they purport to champion. Often they fail to understand the need to trade off quality against price and other features, especially where costs entail considerable sunk assets.

Introduction

The Essential Services Commission review is part of the Government's pre-election commitment program. The ALP energy strategy said,

Labor will establish an Essential Services Commission with powers to:

- *Set performance standards matched by customer service guarantees;*
- *impose tough penalties including fines on utilities that cannot guarantee supply, quality services and environmentally safe practices;*
- *Increase penalties against any utility that causes injury, sickness or property damage to their customers or poor worker safety standards; and,*
- *Establish an independent Essential Services Ombudsman to handle customer complaints and make rulings relating to compensation.*

The ALP Policy to reform the Energy Ombudsman and place it within the Essential Services Commission have been superseded by the reforms announced by the Treasurer on September 6. These created the Essential Services Ombudsman to replace and extend the responsibilities of the Energy Ombudsman.

The Consultation Paper for the ESC sees the ESC subsuming the role of the Office of the Regulator General in its current role as the economic regulator for electricity, gas, ports and grain handling and access to rail freight, and with responsibilities for economic regulation of the water and sewerage industry.

In the review, the Government is seeking:

- to identify how the ESC could contribute towards more reliable utility industries
- views on how the principle of community participation in regulatory decisions by the ESC and other regulators may be further enhanced and how the structure of the ESC and its decision making processes could reflect the views of Victorian consumers
- views on effective ways to improve coordination between regulators.

In this context, the IPA seeks to restrict its submission to some matters it considers to be at the heart of these issues. Our submission is targeted at electricity reviews which have formed the largest component of the ORG's work to date. These matters also have a bearing on the regulatory approaches to gas, water, ports and grain handling and other areas that the ORG/ESC may have jurisdiction.

Outcomes in Energy Since Privatisation

By any measure, the performance outcome of the Victorian energy industry has been impressive since privatisation and, indeed, since 1989 when the Victorian Government first commenced steps which combatted the waste and over-staffing then prevalent throughout the industry.

Not only have staffing levels been cut but, as the ORG has demonstrated, the reliability of the system has been markedly improved.

This improvement has been accompanied by considerable second round changes in ownership. Of the fourteen major entities sold between 1995 and 1999, nine have undergone or have pending subsequent significant ownership transformations. There have been several reasons for this:

- GPU first bought a half share of the smallest distributor, Solaris but was required to sell this (to its partner, AGL) when it bought the Victorian electricity transmission business, Powernet; it subsequently bought the gas transmission business, Gasnet. Due to other financial difficulties, it has decided to concentrate on the US market and has sold Powernet and is seeking a buyer for Gasnet
- Scottish Power's acquisition of Pacificorp, the original owner of Powercor and one fifth of the Hazelwood generator, has brought a wish to concentrate on the UK and US assets
- Entergy sold out of its Citipower acquisition for domestic US reasons
- Powergen has made a decision to sell its half share of the Yallourn generator to concentrate on UK and US assets
- CMS is seeking to exit its half share of the Loy Yang generator because of poor returns.

The pattern is illustrated in Table 1 below.

TABLE 1

Entity	Date sold	Sale Price	Original Purchaser	Subsequent Events
United Energy	August 1995	\$1.553 billion	AMP/ Axiom/ Utilicorp	42% floated 1998; current value \$2.5 billion ¹
Solaris	October 1995	\$950 million	AGL/ GPU joint venture	GPU sold its share to AGL 1997
Eastern Energy	November 1995	\$2.08 billion	Texas Utilities Australia	
Powercor	November 1995	\$2.15 billion	PacifiCorp bought by Scottish Power	Sold to Hutchison Whamoa for \$2.3 billion
Citipower	December 1995	\$1.575 billion	Entergy Corporation	Sold to AEP for \$1.6 billion 1997
Yallourn Energy	March 1996	\$2.426 billion	PowerGen (50%), ITOCHU, AMP, Axiom and Hastings Fund Management	Powergen considering selling non-UK assets
Hazelwood/ Energy Brix	August 1996	\$2.357 billion	National Power, Destec, PacifiCorp and others	Pacificorp/Scottish Power share (20%) sold for \$90 million
Loy Yang B	April 1997	\$84 million (plus \$1 billion. obligations)	Edison Mission Energy	
Loy Yang A	April 1997	\$4.746 billion	CMS 50% NRG 25% others 25%	CMS seeking to sell its 50% stake
PowerNet Victoria	October 1997	\$2.555 billion	GPU	Sold in 2000 to Singapore Power for \$2.1 billion
Southern Hydro	November 1997	\$391 million	Infratil Australia/Contact Energy Consortium	1999 Consortium restructured with Contact exiting
GAS				
Westar & Kinetik Energy	January 1999	\$1.617 billion	Texas Utilities	
Multinet / Ikon Energy	March 1999	\$1.97 billion	Consortium -Utilicorp United Inc, AMP	
Stratus / Energy 21	March 1999	\$1.67 billion	Boral / Envestra	
Transmission Pipelines Australia	May 1999	\$1.025 billion	GPU Inc	For sale

¹ Planned partial float of UeComm values this part of the business at \$1 billion.

Reviewing the Regulatory Approach

The Regulatory Rationale

The consultation on the Essential Services Commission offers the Government an opportunity to review the operations of the ORG and whether it has fulfilled the expectations of it. This will form the basis of any modifications that will be made whether the Government creates an Essential Services Commission or takes a different approach.

At the outset of the reform process under National Competition Policy, the concerns were to:

- place the regulatory body at arms length from the political process;
- ensure that regulatory oversight was restricted to areas of natural monopoly where competition was unable to provide the disciplines to efficient operations; and
- apply an incentive form of regulatory control, CPI-X, which allowed the regulated business to profit from efficient operations.

The requirements stemming from these three basic concerns have only been totally fulfilled in the case of the first—the ORG, like regulatory bodies at the Commonwealth level and in NSW—is genuinely at arms length from the government.

Oversight of Natural Monopoly

With respect to the second of the concerns, ensuring the regulatory oversight is restricted to natural monopoly, regulatory bodies have sought to extend their ambit into areas of competition. Most notoriously this has taken place with the ACCC and NCC in gas transmission (especially in the decision to require regulated access to the competing Moomba to Sydney and Bass Strait to Sydney pipelines). However it is also seen in rail with the NCC's decision to seek coverage of Rio Tinto's West Australian iron ore rail lines and in telecommunications with the ACCC oversight of Telstra business components that are open to competing suppliers.

This discovery of reasons for continuing regulation when competing providers are present appears to be endemic among Australian regulatory bodies. The ORG faced similar issues in the case of the Docklands development where two businesses both wished to install electricity lines. The ORG's pre-determined view was that electricity lines are natural monopolies. Its reaction to an outbreak of competition between two robust businesses was to refuse to modify its paradigm and to declare the competition either "wasteful" or highly imperfect. Although it permitted both the two rivals to offer services to the area, it placed onerous conditions on the supply of services which have constrained the commercial rivalry.

This reluctance of regulatory bodies to exit a field of responsibility where the basic premise underlying regulation no longer operates may reflect a simple wish to avoid

losing influence in economic management. It may also reflect risk aversion on the part of the bodies—if the outcome of the competition in the field where the regulators have rescinded responsibility is not in accord with forecasts, the regulator may incur some unwarranted stigma.

It would be important for the review to re-affirm the need for the regulator agency to remain focussed on areas of natural monopoly. It should offer guidelines that require the regulator to cease regulating where there is evidence of meaningful actual competition in the regulated product or clear evidence of it being contestable.

Pricing of Services

The share transactions that have taken place since the privatisation process are one measure of the success or otherwise of the process. It has been claimed that the buyers overpaid for the assets, and if so this would need to temper judgements. However, for the lines businesses, information that has become available on the public record indicates that the *underbidders* valued most of the businesses sold at similar levels to the successful bidders. This would indicate that on the material available to the bidders in the Information Memoranda and from other sources, the prices bid at the time were indicative of the fair market value.

In setting prices for the regulated businesses, two questions are particularly relevant:

- do the prices allowed accord with the levels expected at time of sale?
- does the price setting formula and the means of reaching a price accord with principles that encourage the firms to search for efficiencies and avoid expenditures that offer no societal gain?

Have prices for regulated services been in accord with expectations at time of sale?

The value of the distribution businesses is overwhelmingly dependent upon regulatory decisions. If the value of the business at re-sale is considerably different from that set at initial sale, several questions are invited. If the value at resale is considerably in excess of the original price, this might reflect initial under-valuations, perhaps because of insufficient competition among potential buyers. None of the Victorian asset sales exhibited such deficiencies.

Where businesses have sold at sharp premiums in second round sales (or are valued far in excess of original sale prices at the times of privatisation) this then is a measure of management skills in unlocking previously under-performing assets or successfully developing the businesses. Although some spectacular increases in value have taken place following some Australian privatisations (e.g. Tabcorp and CSL have increased in value over 400% and 1,600% respectively since their 1994 floats) there has been no such value increase in the energy industry.

Where prices have fallen to a discount of the original sale price, this may reflect unexpected market changes (as has been the case in the generation sector). Lines businesses are, however, regulated monopolies and not greatly dependent on market changes.

Even after the asset sales have taken place, the Government cannot be oblivious to their subsequent valuation. If the change in valuation is due to government as a regulator (or responsible for the regulator) shifting the goalposts, this will adversely reflect on general perceptions of the government and may have negative repercussions at a later stage. In fact, such repercussions may never be identified—business firms will often not trumpet loss of confidence but will instead quietly downgrade a jurisdiction's attractiveness.

There are subsequent market valuations of five Victorian energy business or groups of businesses that are best described as highly dependent on regulated price and service levels. These are:

- Powernet
- Citipower
- United Energy
- Powercor, and
- the gas distributors.

The valuations of these businesses is set out in Table 1.

Powernet

In the case of Powernet, the second round price entailed a fall in value of \$400 million (17%) over the three years 1997-2000. Set against the average valuations in the ASX All Ordinaries, the reduction is even greater—during the period of GPU's ownership the All Ordinaries index increased in value by 15% (while the Infrastructure and Utilities Index increased by 38%). Hence, compared with the market, Powernet showed a value reduction of 32-55%.

There are no suggestions that the business was poorly managed. Accordingly, the main reason for the decline in value is likely to have been the ACCC regulatory price re-sets for Victorian gas transmission and NSW electricity.

- Powernet's regulated income was set at 9.22% on a pre-tax real basis in 1997 at the time of privatisation (representing a reduction from 10.55%). This is to be reviewed by 2002.
- The ACCC's decision on Victorian gas set a regulated return based on 7.75% real pre tax return in October 1998
- The ACCC's 2000 decision for NSW's Transgrid set the regulated return at 7.35% pre tax.

CitiPower

CitiPower's original owners resold the business for a similar amount to the price originally paid (though the transaction took place in 1997 prior to the re-set getting underway).

United Energy

United Energy has a stock market valuation of about \$1.3 billion. To place the business on a comparable basis to its original sale price would require the addition of \$865 million of debt accompanying the sale, valuing it at \$2.17 billion.

The business sold for \$1.55 billion in 1995. However several factors mitigate against using the comparison with \$2.17 billion as an indication of regulatory driven valuation increases. The first is that UE was the first Victorian asset sale and sold at a lower valuation than subsequent sales. Secondly, the business has floated the telecommunications arm (UE Com) it developed post privatisation. This newly developed line of business has a market valuation of about \$735 million, 67% of which is retained by UE, in principle comprising some \$500 million of the worth of the business.

Adjusting for the second factor alone would value the rest of the business at \$1.67 billion or 7% above its original purchase price. The All Ordinaries Index has increased by nearly 50% since United was sold², hence relative to the market as a whole the value of the energy business is down by 43%.

This said, the changes in company profile (including its recent divestment of the retail arm into Pulse) make it difficult to use United to establish more than a rough yardstick against which the regulatory performance can be judged.

Powercor

The recent sale of Powercor may present a clearer measure than the others of the impact of regulatory decisions on business values since it came after the ORG had made the draft determination. This required an initial distribution charge price reduction for the business of 20.3% (reduced to 19.6% in the final determination) and a 6.7% post-tax real weighted average cost of capital (WACC).

The fact that the business reportedly sold at a premium of \$150 million (7%) on its 1995 sale price is a prima facie indication that the draft decision has not resulted in regulatory "expropriation". The ORG would take comfort in the headline measure of regulated price being approximately in line with market valuations. On this basis, though the 6.7% post tax real WACC on the electricity businesses is similar to the 7.35% pre-tax real used by the ACCC, it does not appear to have detracted from the business's value.

However, a number of factors also need to be taken into consideration:

² There is no comparable Infrastructure Index for 1995.

- First, over the period that Pacificorp owned the business the All Ordinaries Index increased in value by 45% hence the premium compared to the market average was -38%.
- Secondly, the business has been successful as a retailer and some premium would be warranted as a result.
- Thirdly, in addition to this success, the firm won a lawsuit against Pacific Power, estimated to be valued at over \$300 million. Although this was settled after the sale of the business, the settlement is thought to have involved “true ups” that factored in the anticipated legal win.

Gas businesses

As shown in Table 1, the gas distribution businesses were sold during the first half of 1999. The sales attracted comparable premiums to those commanded by the electricity distributors three years previously. Significantly, the sales were made after regulatory determinations not dissimilar to those of the ORG’s May 2000 draft. These privatisations would appear to indicate that the specific profit control determinations were in accord with market expectations.

There are some differences between gas and electricity, the importance of which are unclear. Notably, the retail aspects of gas were thought to be relatively more important vis-a-vis distribution than is the case with electricity. In addition, the buyers of the gas businesses were able to envision operational synergies with other parts of their businesses, which was not the case with the electricity sales.

Does the price setting formula encourage firms’ search for efficiency?

In regulating the distribution businesses, the ORG has departed from the spirit, and possibly the letter, of its requirements to apply a form of CPI-X rate regulation³. Instead, it adopts a building block approach which seeks to establish an efficient capital, and operating and maintenance cost base for each distribution business and

³ KPMG puts this as follows. “By interpreting the relevant elements of its statutory framework as providing it with “considerable flexibility about the detailed form of the price control to be adopted for distribution services”, ORG has adopted a questionable interpretation of its mandate. ORG’s interpretation is questionable particularly where it considers that it has flexibility to set a cap on all or part of a distributor’s total revenue for prescribed distribution services.

“The key elements of ORG’s statutory framework, being clause 9.8.7 of the National Electricity Code and clause 5.10(a) of the Tariff Order, specify that the method of price control is to involve “explicit price capping” and “price based regulation” respectively. That is, the price control regime is to relate to “price” not “revenue”. It is of course possible to interpret “price” as used in the statutory framework to encompass “revenue” where:

- quantity equals one (in which case price *is* revenue); or
- a price control caps revenue solely by price cap formula,
- though such interpretation relates to extreme positions, which are:
- inconsistent with standard usage of the terms “price” and “revenue”; and
- not practical or realistic bases for economic regulation.

“We are concerned that ORG, in its discussion in Consultation Paper No. 3, or in relation to its final decision (if based on its Consultation Paper No. 3), may be open to challenge because it has chosen to adopt a questionable interpretation of its legal mandate.” Response to Consultation Paper No. 3 2001 Electricity Distribution Price Review: The Form of Price Control 15 March 1999

apply various cost of capital values to the latter. Two of the businesses also have some 1995-2000 efficiency gains carried over.

All this calls for an immense quantity of information to be collected from the regulated businesses. In some cases the information is not readily available even to the management of the businesses themselves and in all cases the outcome is unpredictable. It is even difficult to determine why two but not the other three were adjudged to have merited efficiency bonuses—and unless such rewards are well understood, they lack the incentive stimulus they are intended to offer.

The process used has a capacity to replace the search for efficiency on the part of the regulated businesses with a process that allocates resources to gaming the regulator. Hence, unless the present price re-set can be explained as a means of establishing an even keel on which a more hands-off approach is used in future there will be damage to the industry's underlying productivity gain.

There are three approaches that might be used to ensure regulation makes use of market outcomes to engender efficiency:

- use a genuine externally determined CPI-X measure so that the regulated business gets to keep the additional profit stemming from its management activities for an agreed period. That profit is determined by economy wide (or industry wide factors) not the *regulator's* assessment of the firm's "normal" profit levels.
- Establish benchmarks for each of the businesses based on data envelops against good practice in a range of market situations
- Implement a form of profit sharing whereby a standard level of profit is established and the firm and its captive customers share the amount in excess of this

If an efficient industry is to be encouraged, the present re-set must be taken as the foundation for future more predictable and less intrusive resets based on economy- or sector-wide productivity achievements.

Paperburden Costs

Between June 1998 and June 2000, the ORG itself issues 24 papers and consultation documents on the price re-set, held over a dozen public hearings and conferences at which it and other parties made presentations, and received 176 submissions. This documentation varied from pieces a few pages long to those running into hundreds of pages. Much of it covered previously arcane financial concepts as beta factors and WACC, concepts that are rarely understood even among directors of public companies and which are commonly used to value businesses rather than set prices.

The ORG has a budget of about \$8 millions, probably half of which was spent on electricity.

It is difficult to place a cost on all that work to the businesses and others responding to requests and invitations for comment. KPMG estimated a spend of \$1-2 million per year per regulated business. However, this is conservative since it does not count the sums spent in the non-regulatory affairs parts of the business—asset management, business planning and even the CEO—all of which incur costs or diverted effort to support the regulatory affairs role. Nor does it count costs incurred by other respondents.

In addition to the 2001 price re-set, the ORG's work on electricity included Y2K, reports on comparative performance, retail contestability, and investigations like that into the Docklands provision. In itself, the weight of the documentation may understate the resource load that the regulatory arrangements require. Each distribution business has considered it essential to develop a regulatory affairs arm with highly skilled staff and a considerable consultancy budget. Moreover, the regulatory issues are so critical to the profit of the businesses that they are a key focus for the CEO and other areas of each business.

The energies devoted to the regulatory environment are resources that are either diverted from improving business efficiency, or resources diverted from consumers via the prices charged by the businesses or through taxes in the case of the ORG and some other respondents. In all cases the resources are a dead-weight cost. Some means must be found of allowing this weight to be lightened and the key to this is by having a price re-set system that is more predictable and automatic.

The Structure of the ORG

The Consultation Paper asks whether the ORG's system of a single regulator or a system with number of commissioners is preferable. It goes on to ask whether consumer representation would be appropriate.

The IPA is mindful in addressing this issue that governments often prefer to be able to make a number of appointments as this enables an extension of their patronage powers. In NSW, the creation of different electricity businesses and other corporatised businesses has presented opportunities to reward loyal supporters or provide a means of supporting those who have had political office or may wish to seek it in future. The appointment of Mr Unsworth and Ms Jennie George to different boards are cases in point.

Although politicians may welcome the ability to exercise such patronage (and possibly benefit from it at certain times in their careers) its abundance detracts from good government. Accordingly, we would tend to oppose the creation of a commission. This position also has a bearing on the integrity of the regulatory body—it would be highly damaging for commissioners to be appointed that were beholden in some previous or prospective way to the government of the day.

We would be even more opposed to having a commission that sought to integrate specific interests. The paper instanced the need for the ESC structure to reflect the important role of consumers.

It goes without saying that consumers have an important role, indeed the most important role. Enfranchising individuals to represent them is a different matter. More often than not those selected for that role tend to be activists, generally hostile to the productive process, particularly the private sector's role. Sometimes consumer "representatives" see their role as ensuring the cheapest price and highest quality with little consideration for costs. At other times they advocate a policy of ensuring that "disadvantaged" consumers (including those who consume less, are located in places where it is more expensive to serve, do not pay their bills, etc.) obtain equal service to all others.

Commissioners of that sort could be deleterious to the efficient operations of the ESC. Indeed, it would be regrettable if the ESC were to be given a "balanced" representation since the "stakeholder" groups could range from consumers to workers to owners of capital to large customers, rural and urban customers, and so on. Establishing a Commission that purported to represent all of these individually would lead to an unwieldy organisation and one that arrived at negotiated outcomes and lost the focus of ensuring the efficient operations of corporations. We should not lose sight of the reason for a regulatory commission, i.e. the absence of the kind of disciplines that are part and parcel of competition in a true market. A regulatory commission is there to replicate market forces and not to act as a welfare agency. Any override of the sort of outcomes that might emerge from a market system are properly those of the Government. To bury these within a regulatory agency would reduce the transparency of processes that are properly overseen by the Parliament.

These sorts of matters are recognised within the Government's paper (p. 18) when it says

Combining diverse regulatory functions and objectives within one organisation could lead to a loss of focus or even conflicts of interest. It would also add a new layer of regulation of final product regulation and it is not clear how these considerations should be weighted for different types of regulatory decisions.

- some of the trade-offs between these objectives - such as cost to consumers in relation to reliability of supply - are more properly made by Government, rather than by an independent (unelected) regulator;*
- the scale and scope of such an organisation would be large and difficult to manage as each regulatory responsibility requires specific knowledge and expertise.*

Consultation

The Consultation Paper asks:

- *How could the existing public consultation processes undertaken by utility regulators -including the ESC - be improved to ensure greater transparency, particularly where regulatory objectives involve trade-offs (for example, between price and levels of service)?*
- *Is sufficient financial and other information on the regulated businesses currently made available?*
- *How could existing public consultation processes be more accessible, particularly to groups that are disadvantaged and poorly resourced?*
- *What roles and mechanisms are required to ensure constructive consumer advocacy in regulatory processes?*

The ORG in its road shows and in the considerable detail it requires from the regulated businesses is already requiring considerably more information be placed on the table than that sought of other businesses. Indeed, the information is probably too comprehensive for the ORG to digest.

Doubtless some advocacy groups would like to draw from the public purse or from subventions required from regulated businesses in order to undertake increased analyses. It is a matter for policy whether the government decides to fund or increase the funding of pressure groups from budgetary resources. However, in the context of regulatory requirements on businesses, such claims should be resisted since they make it more difficult for the public and the government itself to determine overall tax and quasi tax measures it is imposing on the community generally. It is, of course, another matter for the groups themselves to seek out voluntary funding, as the IPA does.