Regulatory issues

Eastern Gas Pipeline

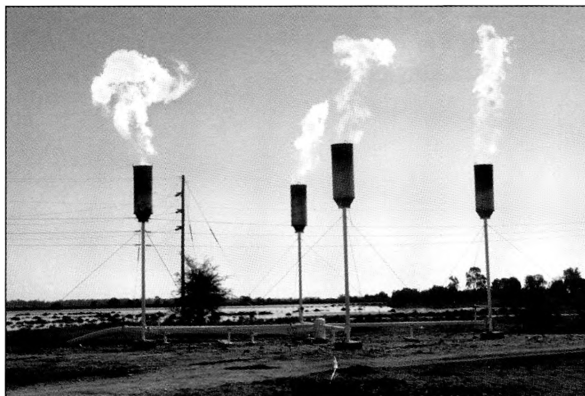
The Australian Competition and Consumer Commission and the National Competition Council (NCC) are resolving how to regulate access to the services of the Eastern Gas Pipeline which is currently under construction.

When completed, it will run from Longford in Victoria to Horsley Park in Sydney and will be capable of supplying Bass Strait gas to Sydney and other markets en route.

On 18 November 1999 the owner of the pipeline, the Duke group of companies, gave an undertaking to the Commission on how it proposed to provide access to the transport and other services of the pipeline.

On 7 January 2000 AGL Energy Sales and Marketing Limited applied to the NCC for coverage of the Eastern Gas Pipeline under the National Gas Access Code. If the pipeline was covered under the code, the Duke group would have to submit an access arrangement to the Commission that met the requirements of the code.

The Commission and NCC are discussing how to deal with the undertaking and coverage processes in a way which won't compromise whether access should be granted to the pipeline services and, if so, the form of access.



Access to the services of gas pipelines

Such access typically involves a contract between the pipeline owner or operator and a third party which gives the third party the right to transport gas through the pipeline on certain terms and conditions, and on payment of a transport tariff.

The parties can negotiate access under Part IIIA of the Trade Practices Act, where the pipelines meet the specified criteria and if they have spare capacity.

The Commonwealth Government enacted Part IIIA to promote more efficient use of monopoly or near-monopoly facilities, where it would be uneconomical for anyone to develop another facility, and where access would promote competition in another market.

It is yet to be determined whether the Eastern Gas Pipeline falls within Part IIIA.

Provisions of Part IIIA

Part IIIA provides three methods for gaining access to the services of monopoly or near-monopoly facilities:

- through declaration of the facility, which creates a right for a third party to negotiate for access to any spare capacity;
- under an access regime established by a State or Territory and judged to be effective under Part IIIA; or
- under an undertaking submitted by the owner or operator of the facility and approved by the Commission.

The States, Territories and Commonwealth agreed to establish identical access regimes for gas pipelines. Each passed legislation providing for access to covered pipelines in accordance with the National Gas Access Code.

FLOW Communications Pty Limited and Telstra Corporation Limited

FLOW Communications Pty Limited has notified the Commission of an access dispute with Telstra Corporation Limited under Part XIC of the Trade Practices Act.

The dispute primarily relates to the prices charged by Telstra to FLOW for Domestic PSTN Originating Access Service. These services enable the origination of calls from Telstra's PSTN network. The originating services were declared by the Commission on 30 June 1997, pursuant to s. 39 of the *Telecommunications (Transitional Provisions and Consequential Amendments) Act 1997.*

The Commission has begun the arbitration process although it will not be making any public comment at this stage.

Mobile long-distance services

On 14 January 2000 the Commission issued the final report on its decision not to declare a long-distance mobile originating service.

Such a declaration would have required mobile telephone network operators to allow service providers to supply the long-distance component of calls from mobile phones.

Mobile services in Australia are currently delivered by three network operators — Telstra, Cable & Wireless Optus and Vodafone — plus a number of resellers of mobile services including Hutchison, One.Tel and AAPT. These latter companies have also acquired spectrum and are starting to roll out their own mobile networks.

When complete, Australia will have at least five mobile network operators in its main population centres and up to four in regional areas — one of the highest numbers of suppliers of mobile services in the world.

Consequently, the Commission believed that declaring the long-distance service would be unlikely to lead to more vigorous competition than would otherwise happen.

But the Commission will continue to closely watch call charges in the mobile market.

GSM mobile terminating services, which carriers and service providers pay to terminate a call, are already declared. The prices charged for these services have a direct bearing on prices paid by consumers for calls from fixed phones to mobiles and for mobile calls between networks.

The Commission can determine the terms and conditions, including prices, for supply of these services. It is currently conducting a number of arbitrations in relation to these services and has issued a discussion paper on pricing issues.

Access to NT electricity networks

The Northern Territory Government has asked the National Competition Council to consider whether the Territory's regime for access to its electricity networks is effective. The NCC released an issues paper and sought written submissions by February 2000.

Part IIIA of the Trade Practices Act establishes a national regime for the provision of electricity networks. However, a State or Territory Government access regime which has been found to be effective will override the national regime. To do this, the regime must be certified by the Commonwealth Minister for Financial Services and Regulation, as recommended by the NCC. Once certified, other pathways to regulated access, such as 'declaration' under Part IIIA, cannot be invoked.

The NT Electricity Access Regime sets out the rights and obligations of the parties providing or seeking access to specific NT electricity networks.

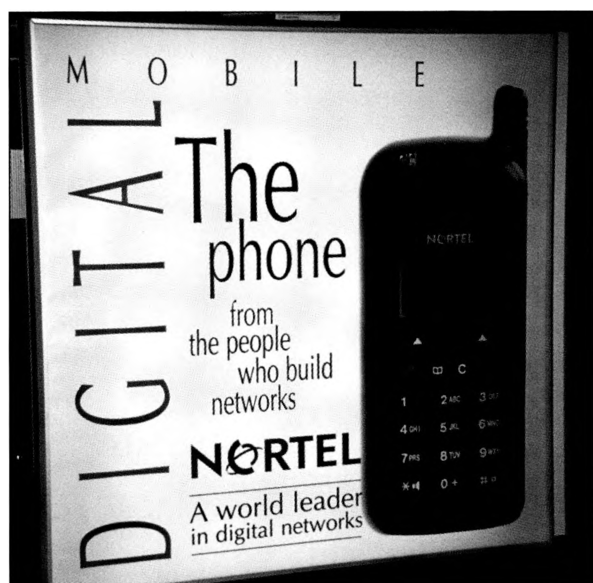
The issues paper can be found at http://www.ncc.gov.au.

New draft pricing for mobile number portability

The Commission issued its draft pricing principles for mobile number portability on 18 February 2000.

Pricing Principles for Mobile Number Portability — a draft guide sets out the principles the Commission will apply if it has to arbitrate a dispute over the terms and conditions of mobile number portability between the service deliverers and service providers.

Mobile number portability allows a customer to change their mobile carrier and/or service provider without having to change their mobile phone number.



The Commission believes service deliverers and mobile carriers should be responsible for their own system set-up and customer transfer costs of providing portability. Service deliverers should also be responsible for all efficient call conveyance costs that result from their choice of how to provide portability.

The current lack of portability impedes competition by locking in customers to particular service providers and makes it difficult for new entrants to attract these customers.

The draft pricing principles present service providers with the right incentives to provide mobile number portability in the most efficient and low-cost fashion which ultimately will benefit customers.

The Commission sought comments on the draft principles by 17 March 2000.

NSW and ACT electricity network revenue caps

On 25 January 2000 the Commission decided the revenue cap for the electricity transmission networks in NSW and the ACT. The decision sets the maximum revenue that TransGrid and EnergyAustralia may earn in providing non-contestable electricity transmission services in NSW and the ACT and concerns the physical infrastructure used to transport high voltage electricity.

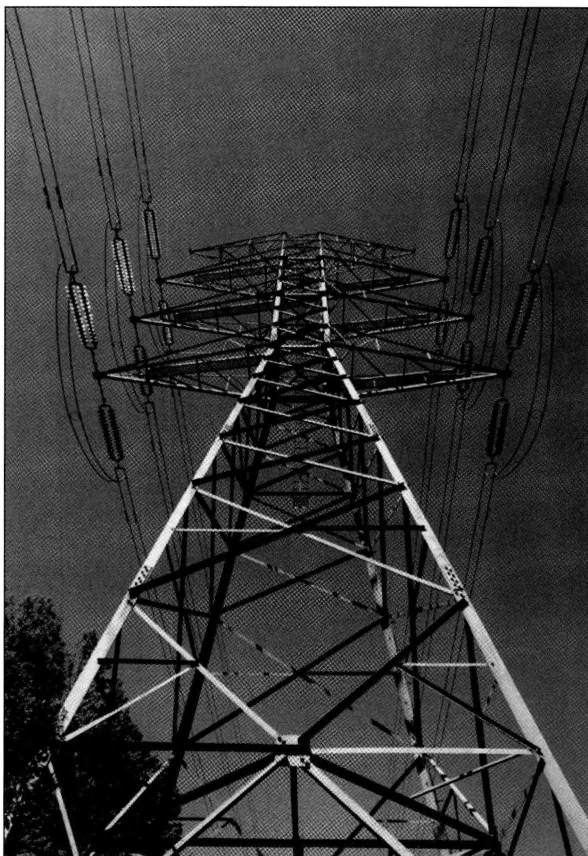
This decision, made under the National Electricity Code (NEC) and NSW's transitional rules, is the first by the Commission as the economic regulator of electricity transmission in the National Electricity Market (NEM). It will apply from 1 February 2000 to 30 June 2004. The Commission will regulate the remaining NEM transmission networks on a progressive basis in accordance with each State's transitional arrangements.

The Commission's approach

The NEC requires the Commission to set a revenue cap with an incentive mechanism (such as CPI-X or some variant) for non-contestable transmission network services. TransGrid will calculate the network prices firstly in line with NSW's transitional derogations and then with the NEC.

The Commission is developing the regulatory framework and released a draft Statement of Principles for the Regulation of Transmission Revenues (Regulatory Principles) in May 1999.

The revenue cap decision is part of the transition towards the Commission's Regulatory Principles framework. In the future revenue caps will be determined using the Regulatory Principles.



Having adopted an accrual approach to determine the caps, the Commission used a post-tax nominal formulation. It has allowed for a pass-through of costs to take account of the GST and a possible pass-through for increases in third party liability insurance premiums. Therefore, the revenue cap is the sum of:

- a **return on capital** — which is the written down (depreciated) value of the asset base multiplied by the post-tax nominal weighted average cost of capital (WACC);
- the **return of capital** — depreciation allowance;
- an allowance for **operating and maintenance expenditure;**
- **tax** — expected business income tax payable;
- **insurance** — possible pass-through of material, efficient and reasonable additional third party liability insurance costs; and
- **GST** — pass-through of the net impact of the goods and services tax on the businesses.

Revenue cap for TransGrid

To establish the appropriate return on the funds invested in TransGrid, the Commission has modelled TransGrid's asset base over the life of the regulatory period — 1 February 2000 to 30 June 2004. Broadly, the closing value of TransGrid's asset base is constructed by converting its opening real value to a nominal figure (by adding an inflation adjustment, in this case by 3.15 per cent per annum plus any capital expenditure) and subtracting the depreciation and asset sales (disposals) for the year. The closing value for one year's asset base becomes the opening value for the following year.

The Commission set the opening value of TransGrid's assets at $1935 million.

TransGrid plans to spend $946 million on capital investment over the coming years. Under the NEC, the Commission aims to provide TransGrid with enough funds to undertake prudent investments but to assess the efficiency of the actual investments when the revenue cap is next reviewed.

The Commission included $881 million of capital expenditure in calculating the cap. This figure includes interest during construction but excludes several proposed projects on the basis of their projected timing and current uncertainty.

Calculation of the depreciation component has been based on the straight-line method using the remaining life per asset class. Moreover, as part of the post-tax nominal framework, the Commission has also allowed for 'economic depreciation' which adds the (negative) straight-line depreciation with the (positive) annual inflation effect on the asset base. Using this approach the Commission can:

- normalise the tax payable estimates over the life cycle of the assets to address the so called 'S-bend' phenomenon; and
- remove the additional return the networks would otherwise earn on the tax allowance that has been brought forward.

Economic depreciation has been used to model asset values over the life of the regulatory period (table 1) and to determine the return of capital (table 2).

The WACC, commonly used to calculate the return expected on an asset base, is important as the return on capital can account for around one-third of the revenue cap.

While the WACC framework provides a well-recognised model for establishing the cost of capital, there is less than full agreement on the precise size of the financial parameters that should be applied. The Commission has carefully considered the value that should be assigned to TransGrid given its business and current financial circumstances.

The appropriate rate of return on equity to apply to TransGrid is a post-tax nominal rate of 13.85 per cent. This equates to a post-tax nominal WACC of 8.30 per cent. The Commission believes these figures are towards the higher end of the feasible range and has made an upward allowance to account for risk perceptions attributable to the newness of the regulatory regime.

Based on the above components, the Commission has modelled TransGrid's asset base over the life of the regulatory period (see table 1).

Table 1. TransGrid's return on capital, 1999–00 to 2003–04 ($ million)

	1999–00	2000–00	2001–02	2002–03	2003–04
Opening asset base	1934.54	1961.01	2011.95	2260.87	2309.44
Capital Expenditure	52.61	82.08	285.95	90.53	370.42
Economic depreciation	(26.14)	(31.14)	(37.03)	(41.96)	(47.12)
Closing asset base	1961.01	2011.95	2260.87	2309.44	2632.74
Return on capital	197.72	200.42	205.63	231.07	236.03

Table 2. Final MAR (maximum allowed revenue) for TransGrid, 1999–00 to 2003–04 $ million)

	1999–00	2000–00	2001–02	2002–03	2003–04
Return on capital	197.72	200.42	205.63	231.07	236.03
Return of capital	26.14	31.14	37.03	41.96	47.12
Operating expenses	101.30	102.93	104.57	106.25	107.95
Estimated taxes payable	8.95	9.75	10.04	13.33	15.31
Less value of franking credits	(4.47)	(4.88)	(5.02)	(6.67)	(7.66)
Unadjusted revenue allowance	329.63	339.36	352.25	385.94	398.76
Smoothed MAR	**329.63**	**344.47**	**359.98**	**376.19**	**393.12**

The Commission included provision for a real saving in TransGrid's operating expenses of approximately 7.5 per cent over the regulatory period or about 1.5 per cent a year.

The Commission has assessed TransGrid's taxation position based on the assumptions underlying the above components, its tax depreciation profile and the proposals in the Ralph business taxation review. The latter will reduce the 36 per cent company tax rate and remove accelerated depreciation allowances (although these are grandfathered for assets in service before September 1999). The Commission has allowed for taxes payable to range from $8.95 million in 1999–2000 to $15.31 million in 2003–04.

Under the previous regulatory regime administered by IPART (the Independent Pricing and Regulatory Tribunal of NSW), TransGrid's revenue has been around $350 million a year over the last four years and its regulated revenue for 1998–99 was $339 million. TransGrid has argued for a net revenue cap growing from $357.94 million in 1999–00 to $455.45 million in 2003–04.

Based on its assessment of the Australian economy at present, as well as TransGrid's expenditure program, the Commission has determined a maximum annual revenue for TransGrid which ranges from $329.63 million in 1999–00 to $393.12 million in 2003–04.

Because the cap has been constructed using a CPI-X efficiency regime, TransGrid can roll forward the opening revenue of $329.63 million adjusted each year for changes in the consumer prices index (CPI) plus an X-factor of 1.3 per cent a year. The X-factor ensures that TransGrid receives the real value of the projected revenue stream. The final revenue stream also reflects the operating expenses efficiency reductions of 1.5 per cent. The CPI figure may need to be adjusted for the impact of the GST in future years.

Allowing for the impact of this decision, TransGrid's credit rating is likely to move from AA to A over the regulatory period. This is largely due to the ambitious planned capital expenditure program. The Commission is satisfied that, in the circumstances, the proposed revenue stream is appropriate and sustainable.

Finally, the Commission proposes to include a pass-through item for the 2000–2001 financial year to address the impact of the GST. This will net out the impact of the GST against the impact of removing the wholesale sales taxes. Because TransGrid will be shielded from the impact of the GST the Commission will not allow TransGrid to gain from the GST by including its inflationary effects in the CPI incentive mechanism. The Commission will work with the networks and the State regulators to derive an appropriate CPI adjustment factor.

Revenue cap for EnergyAustralia's parallel transmission assets

The Commission has also determined a revenue cap for EnergyAustralia's parallel (66 kV to 220 kV) transmission network. IPART regulates EnergyAustralia's non-parallel transmission network and its distribution network.

Although the Commission has generally been consistent in setting the revenue caps for both EnergyAustralia and TransGrid, EnergyAustralia's transmission services are largely integrated with its distribution services. The Commission has therefore considered the network's integrated business rather than trying to maintain consistency for its own sake.

EnergyAustralia's initial asset base is comprised of network assets valued at $389.4 million, and easements valued at $72.5 million. These valuations were calculated from the depreciated replacement cost for EnergyAustralia's optimised network assets, and the inflated historic cost of the easements.

EnergyAustralia proposed an $80 million capital expenditure program for its parallel transmission network, consisting of $46.4 million for augmentations, $24.9 million for renewal expenditure for mains and $8.7 million for substations. The Commission accepted the prudency of this program and included the proposed expenditure in calculating the cap.

The Commission adopted the same approach to estimating depreciation and the post-tax return on equity for EnergyAustralia's parallel transmission assets that it used for TransGrid — that is, a post-tax nominal return on equity of

13.85 per cent. This equates to post-tax nominal WACC of 8.1 per cent. The difference between EnergyAustralia's WACC of 8.1 per cent and TransGrid's 8.3 per cent arises because EnergyAustralia's tax shield from depreciation is proportionately smaller.

The Commission has determined a return on capital for EnergyAustralia's parallel transmission assets from $46.70 million in 1999–00 to $46.81 million in 2003–04.

Given the degree of integration of operating and maintenance across EnergyAustralia's network, the Commission has used the same efficiency factor for the parallel network as IPART has used for its distribution network; that is, real reductions in operating expenditures of 1 per cent a year.

The Commission has estimated a revenue allowance for EnergyAustralia's parallel transmission network that grows from $73.10 million in 1999–00 to $78.12 million in 2003–04 (see table 3). These numbers are expressed in CPI-X format where X is 1.43 per cent. The actual revenue stream from year to year will change to account for GST.

Table 3. MAR for Energy Australia's parallel transmission assets, 1999–00 to 2003–04 ($ million)

	1999–00	2000–00	2001–02	2002–03	2003–04
Return on capital	46.70	46.19	46.13	47.00	46.81
Return of capital	8.51	9.50	10.61	11.53	10.32
Operating expenses	16.45	16.71	16.98	17.25	17.53
Estimated taxes payable	2.88	2.94	2.84	3.20	8.04
Less value of franking credits	(1.44)	(1.47)	(1.42)	(1.60)	(4.02)
Unadjusted revenue allowance	73.10	73.87	75.14	77.38	78.68
Smoothed MAR	**73.10**	**74.33**	**75.57**	**76.83**	**78.12**