

October 2005 | Final Decision

**Electricity Distribution Price Review
2006-10
Final Decision
Overview**

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PART A: OVERVIEW AND INTRODUCTION

The Commission has made a Final Decision on the prices and service levels applying to the five Victorian distribution businesses for the period 2006-2010. This overview summarises the key outcomes, issues and future regulatory policy implications that have emerged from this, the second major independent review of the electricity distribution charges for the five Victorian monopoly distributors, since the electricity industry reforms of the mid 1990s.

The key theme and objective of this review has been to substantially increase the accountability of the businesses for maintaining and improving the delivery of reliable electricity distribution services to Victorian customers. Reliability of essential services such as electricity distribution services has a significant impact on economic growth, competitiveness and the welfare of all Victorian citizens. The prices paid for distribution services account for approximately 40 per cent of electricity customers' total bills. Moreover, the sale of such services is expected to generate industry revenues of around \$6.3 billion over the next five years. The adequacy of revenue, return and incentive is critical to the necessary investment in, and maintenance of, reliable networks.

Key outcomes of the review

The price controls established for the five Victorian monopoly distribution businesses provide for the financing of \$3.3 billion¹ of capital expenditure for the period of 2006-10. This represents an increase of around 43 per cent above the actual capital investment made by the businesses during the period 2001-2005 including metering, or around 30 per cent excluding metering. The Commission considers that this level of capital expenditure benchmark is more than sufficient to account for the demands of network reinforcement, new customer connections, asset replacement, safety and environmental obligations and the installation of a significant number of interval meters.

The Commission's Final Decision will result in average price reductions of 12 per cent across the industry in 2006, with a further 1.2 per cent reduction per annum over the following four years.² This compares to initial price reductions averaging 23 per cent in the Draft Decision. The adjustment to the initial price reductions between the Draft and Final Decisions has been made in light of further information that supports increases in forecast operating and capital expenditures, a reduction in forecast demand and an acceleration of the depreciation profile for some distributors.

¹ Gross capital expenditure including metering.

² Including metering charges.

In developing the price controls for the 2006-2010 regulatory period the Commission has deliberately adopted a longer term view with a focus on locking in the performance gains made to date as well as providing incentives to improve reliability and customer service to levels consistent with the values placed on them by customers. Substantial increases in both the rewards and penalties imposed under the broadened service incentive scheme will provide distributors with strong financial incentives to improve service performance. These incentives are accompanied by an enhanced system of guaranteed service level payments to bring about improvements in those areas that are currently worst served.

The introduction of strategic initiatives such as the interval meter rollout will also provide a platform for the delivery of improved demand management outcomes and greater efficiency in distribution services and related markets. The interval meter roll out will be managed so that distributors are provided with adequate compensation for the cost of the rollout whilst providing incentives to achieve efficiencies in the cost and volume of installations.

Focus of this review

The Commission recognises that the distributors have achieved a marked improvement in service performance for virtually all customers over the last ten years.

In the time since the industry was restructured, privatised and placed under formal economic regulation, all key indicators of network reliability have shown significant improvement. The broadest indicator of reliability, average customer minutes off supply per annum (or SAIDI), has fallen from 199 in 1997 to 132 in calendar year 2004. The proportion of customers experiencing more than five hours of supply outages (or 300 minutes off supply) has reduced from 20.5 to 11.6 percent over the same period. The annual incidence of interruptions (as indicated by SAIFI) has also reduced significantly.³

Services have not only improved in terms of average network performance, but they have also improved for customers located in those parts of the electricity distribution network that have historically experienced poor performance. There has been significant improvement in the minutes off supply for worst served customers (ESC 2004g, p. 30). For example, Powercor reports that the worst served 15 per cent of customers in its network area have experienced an improvement of 41 per cent since 2000, from an average of 738 minutes off supply in 2000 to 434 minutes off supply in 2004.

Notwithstanding this picture of strong performance overall, there remain some pockets where the level of service has not kept pace with the demands of customers in a growing economy, particularly in some regional areas. As explained below, an important focus of this review has been to establish arrangements that will address these areas of concern.

³ SAIFI is the system average interruption frequency index.

Instrumental in delivering the widespread improvement in services has been the improved operational and investment focus of the distributors. Accountability for delivering services in line with customer expectations ultimately lies with the distributors, and will continue to remain so. Nevertheless, the Commission's experience over two regulatory periods is that the detailed regulatory arrangements governing service performance play a significant role in securing that focus by the distributors, and rewarding it appropriately.

The Commission's highest priority for this review is to secure and enhance this recent performance record into the future. This goal has defined the two main areas of attention for this review:

- augmenting the monitoring and incentive framework applying to service performance, with a particular regard to strengthening the distributors' accountability for delivering reliable distribution network services, including for those customers where service is still not matching reasonable expectations; and
- undertaking a careful evaluation of the future operating expenditure and investment requirements proposed by the distributors, and ensuring that sufficient revenue is available to finance expected changes in the cost of delivering services at current levels, as well as incentive arrangements that ensure continued improvements in service and reliability.

These two areas are closely related. A continued emphasis on maintaining and enhancing the distributors' current performance can only be achieved if expected revenues (and so the prices that customers pay) are sufficient to finance the necessary expenditure to deliver that service. Nevertheless, it is also recognised that irrespective of how much money is made available through the price controls, there is no guarantee that the distributors will undertake the investment necessary to secure and enhance network reliability or indeed the investment that they have proposed to make. Intrinsic to a strengthened accountability framework is the principle that some portion of distributors' expected revenues should be conditional on the achievement of desired levels of reliability. Importantly, customers should not be expected to pay for reliability improvements promised but not delivered.

Enhanced accountability

In developing its approach to increasing the accountability of the distributors, the Commission has drawn a distinction between establishing capital expenditure and operating and maintenance expenditure forecasts sufficient to maintain the delivery of current service performance in line with 'business as usual' and the arrangements for identifying and funding opportunities to invest in further service improvements.

Business as usual expenditure has been provided for within the 'building block' revenue requirements that underpin the principal price controls which are outlined in more detail in the following sections. This expenditure does not include an allowance for improvements to

existing average service reliability levels but does allow for improvements in quality of supply. The targeted levels of service reliability for the purpose of reporting and monitoring in the 2006-10 regulatory period have been set equal to the 2005 targets, except where a distributor has been consistently outperforming this target. In this case, the current level of performance has been considered in deciding a new target

The most significant measure in this Decision for ensuring that the distributors deliver the services that they are paid to deliver is an increase in the rewards and penalties under the service incentive scheme (the ‘S-factor’ in the price controls).

These rewards and penalties will apply for any improvements or shortfalls in service performance outcomes through changes to the distributor’s allowed revenue. These adjustments are symmetric: not only will distributors receive additional income when service enhancements are achieved but also they may incur penalties of a similar magnitude if service performance is not delivered.

Under these arrangements the distributors — rather than the Commission — will be responsible for identifying and deciding upon initiatives that will bring about service improvements, with the rewards then flowing once those service improvements are delivered. This will facilitate delivery of the optimum level of service, given the value customers place on service and the cost to deliver this level of service.

The main improvements made to the incentives for service provision include:

- increases in the incentive rates;
- adopting a uniform incentive rate for all distributors;
- broadening the range of indicators that are subject to the financial incentive;
- substantial increases in the value of Guaranteed Service Level (GSL) payments;
- broadening of the monitoring regime; and
- a quantitative rather than qualitative approach to excluding supply interruptions from the calculation of the S-factor and the obligation to make GSL payments.

The incentive rates for the current price control period were set by reference to the estimated marginal cost of delivering service improvements. These costs were inherently uncertain and varied significantly from one distributor to another. For the 2006-10 period, the incentive rates will increase based on a uniform \$30,000 per MWh or 1000 times the average selling price of distributed energy⁴. This value is based on the cost that poor service imposes on customers and is known as the Value of Customer Reliability (VCR) and increases the value up to six times compared to the value that has applied during the 2001-05 regulatory period.

⁴ With the exception of CitiPower’s CBD customers, where the incentive rates will be based on \$60,000 per MWh

The Commission is also broadening the range of indicators that are subject to the S-factor incentive scheme. For the coming regulatory period, the scheme will include new incentives for unplanned minutes off supply, momentary interruptions and call centre performance while also retaining the existing incentive for the frequency of unplanned interruptions. Planned minutes off supply has been removed from the scheme because of the concerns expressed by some stakeholders that it would create an incentive for more ‘live line’ work, potentially resulting in a greater incidence of unsafe work practices. Nevertheless, distributors will continue to report planned minutes off supply on a regular basis.

In addition to incentives provided through the S-factor, the Commission has increased substantially the payments that are to be made to customers where service performance does not meet a guaranteed minimum level. All customers will automatically receive these Guaranteed Service Level (GSL) payments when they experience more than 20 hours, 30 hours and 60 hours of cumulative sustained unplanned interruptions in a year with the GSL payment increasing for each threshold. Customers will also receive a GSL payment where the number of sustained interruptions is more than 10, 15 and 30 in a year, or the number of momentary interruptions is more than 24 and 36 in a year, again with increasing payments for each threshold.

A further measure to be introduced for the 2006-10 period is a broadened of the monitoring regime. This includes:

- additional reporting associated with quality of supply;
- reporting the annual duration and frequency of interruptions (planned and unplanned) experienced by the worst served 15 per cent of customers;
- reporting the causes of unplanned interruptions and the actions the distributor proposes to undertake to improve its performance;
- reporting customer service measures, including call centre performance; and
- reporting other measures of performance that are less amenable to specification in a financial incentive regime.

The Commission is confident that, taken together, these arrangements will significantly increase the accountability of distributors for delivering reliable quality services.

Importantly, the distributors will be able to control the value of the impact of these arrangements. The expected value of the penalties and rewards associated with the S-factor incentive scheme is approximately zero where the distributors do not respond to the arrangements but distributors stand to earn considerable rewards where they respond by investing in their network to achieve service improvement outcomes. This is because the rewards under the scheme have increased significantly whilst the costs of achieving them have reduced as a result of changes to the efficiency carry-over mechanism discussed in later sections.

The Commission anticipates that this will cause distributors to pursue the rewards that will be delivered by carefully targeted and innovative programs to benefit all customers and particularly worst served customers. This will include placing greater emphasis on undertaking investment and operational measures that reduce network outages and their associated inconvenience to all customers. However, customers will only pay for these improvements once they are delivered.

These revised service performance measures should encourage distributors to shift their business focus away from short term cost minimisation and the payments available under the efficiency carryover mechanism towards longer term network planning and management and investment, to avoid the penalties imposed when services are not provided.

Establishing forecast revenue requirements

In addition to enhancing the accountability of distributors for the delivery of services and reliability, the regulatory framework is also focused on the establishment of forecast revenue requirements for each distributor over the forthcoming regulatory period. These revenue requirements are intended to be sufficient for each distributor to recover the efficient costs of operating its network business, including a commercial return on invested capital for “business as usual” service levels outlined in the previous section.

The service delivery and out-turn expenditure performance of the distributors during the 2001-05 regulatory period can be characterised as having achieved more in terms of service delivery, but with significantly less expenditure than the distributors considered necessary in their proposals to the last price review. On readily available measures of industry performance, this combination of outcomes can only be described as virtuous — more has been delivered, for a cost less than expected.

However, the sustainability of the expenditure and service performance outcomes during this regulatory period was not apparent in the expenditure projections contained in the distributors’ submissions to this review. As a group, the distributors proposed average increases in capital expenditure and operating and maintenance expenditure allowances for the 2006-10 regulatory period of 54 per cent and 45 per cent respectively⁵ over their average capital expenditure in 2001-2005 and their average operating and maintenance expenditure in 2001-2005 (see Figures A.1 and A.2).

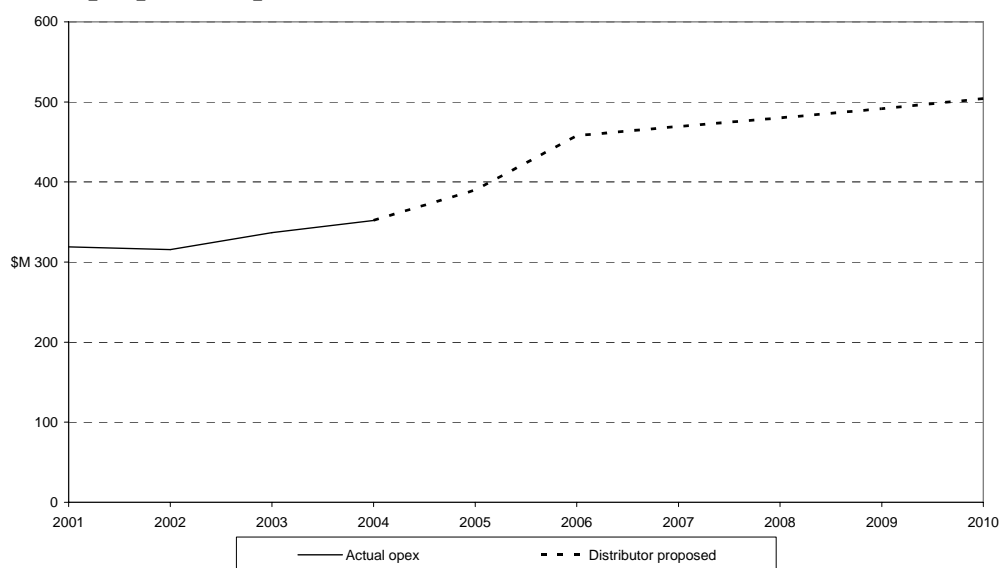
⁵ This is exclusive of the cost of metering. Including metering the distributors’ proposals represent 69 and 62 per cent increases over the average capital expenditure in 2001-05 and their average operating and maintenance expenditure in 2001-05 respectively..

Figure A.1: Capital expenditure (gross), industry aggregate, actual expenditure 1996-2004^a and distributor’s proposed forecast expenditure 2005-10, \$million, real \$2004



^a Out-turn gross capital expenditure includes prescribed distribution use of system and metering costs

Figure A.2: Operating and maintenance expenditure, industry aggregate, actual operating and maintenance expenditure 2001-04^a and distributors’ proposed expenditure, 2005-10, \$million, real \$2004



^a Exclusive of operating and maintenance expenditure associated with prescribed metering services.

The Commission's task of reconciling this seemingly inconsistent combination of historical expenditure requirements and projected expenditure has been far from straightforward. At one end of the spectrum, the distributors' proposals might be characterised as 'ambit claims' in what they take to be a process of negotiation. In this case, an important priority for the Commission is to protect the interests of customers who would otherwise bear the cost of excessive expenditure proposals. At the other end of the spectrum, the distributors may well have identified opportunities where capital expenditure scheduled for the last period was efficiently deferred, but now needs to be undertaken in the coming regulatory period. Reconciliation of these two extremes has been a key challenge for the Commission in reaching its Final Decision.

In its Draft Decision the Commission adopted forward looking capital and operating expenditure forecasts that, at an industry aggregate level, represented real increases in capital and operating and maintenance expenditure of around 5 and 22 per cent respectively⁶ over the level of expenditure for the 2001-05 period. These increases reflected the impact of a number of step changes in operating and maintenance expenditure to account for new or changed functions and regulatory obligations, and increases in the capital expenditure forecasts reflecting the priority accorded by the distributors and the Commission to investing in network renewal, capacity augmentation to meet peak load growth and to comply with regulations regarding electrical safety.

Since releasing its Draft Decision the Commission has had regard to further information provided by the distributors and other stakeholders and the advice that it has received from its technical consultants in relation to the distributors' expenditure requirements for the 2006-10 regulatory period. As a result of this the Commission has revised its position with respect to a number of assumptions underpinning capital and operating cost forecasts as outlined in the following sections.

Capital expenditure forecasts

The Commission has adopted forward looking capital expenditure forecasts that, at an industry aggregate level, represent a real increase in capital investment of around 30 per cent over the level of expenditure for the 2001-05 period (see Figure A.3).⁷ This increase reflects the information before the Commission that indicates that there are reasons why future investment will need to be undertaken at greater than historic levels, for example the ageing of assets, growth in peak demand and improved compliance with safety obligations.

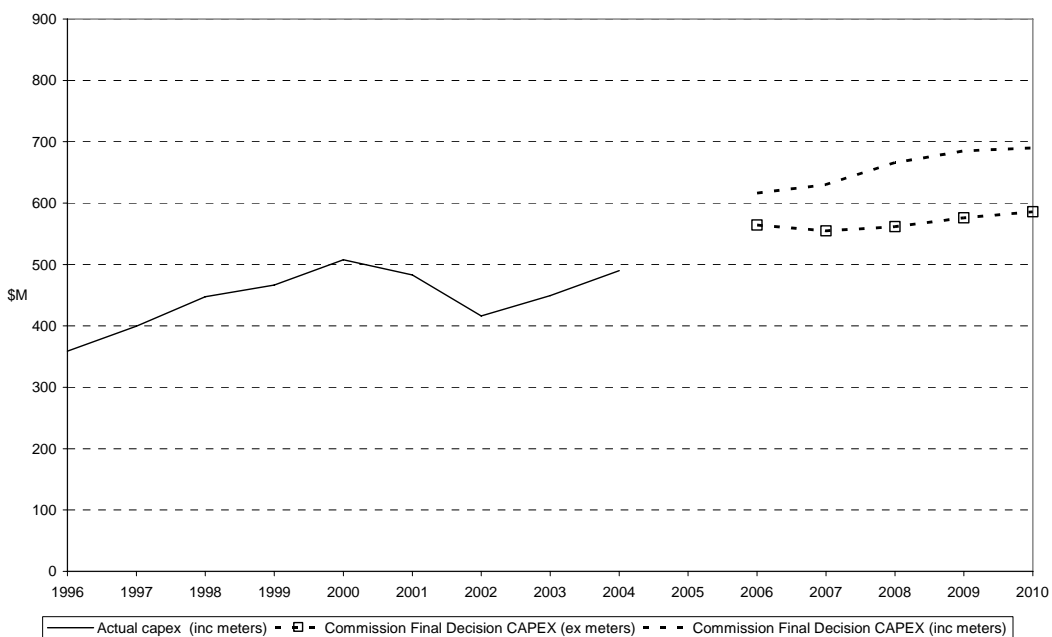
The Commission has recognised that the allowance is less than the allowance claimed to be required by the distributors, and the recommendations from its technical consultants. However, the Commission is satisfied that taking into account the incentives at the time of a price review to over-state expenditure requirements and then within the regulatory period to

⁶ Excluding metering expenditure.

⁷ When expenditure for metering is included, this increases to 43 per cent, at an industry level.

minimise expenditure this allowance is sufficient for the obligations of the distributors with regard to service provision and safety. Further, the Commission has taken into account the removal of the efficiency carryover mechanism which has reduced the cost to the distributors of undertaking investment where required and the significant increase in the rewards where investment delivers reliability and customer service improvements.

Figure A.3: Total gross capital expenditure, industry aggregate, out-turn capital expenditure 2001-04^a and Final Decision 2006-10, \$million, real \$2004



^a Out-turn gross capital expenditure includes prescribed distribution use of system and metering costs

Operating and maintenance expenditure forecasts

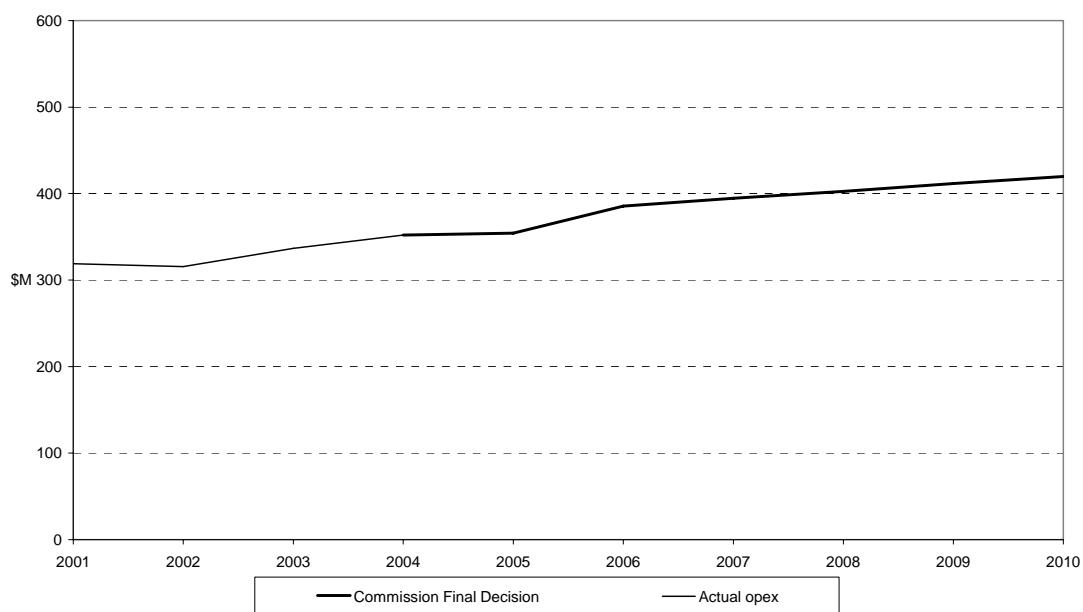
The Commission has adopted forward looking operating and maintenance expenditure forecasts that, at an industry aggregate level, represent a real increase in operating and maintenance expenditure of around 21 per cent⁸ over the normalised level of expenditure undertaken during the 2001-05 period (see Figure A.4).⁹ This increase reflects the impact of a number of step changes (due to new or changed functions or regulatory obligations) after making adjustments for matters such as provisions, changes in capitalisation policies and contractual arrangements reported during the 2001-04 period. Increases in labour costs reflecting recognised skills shortages and the cost associated with growth have also been reflected in operating and maintenance forecasts.

⁸ Excluding metering expenditure

⁹ This calculation assumes that 2005 operating and maintenance expenditure is consistent with the Commission’s Final Decision.

The Commission is satisfied that, although these expenditure forecasts are less than the distributors proposed, they nevertheless provide adequately for future operating needs, and take account of relevant changes in the safety standards to which the industry must work, as well as the continuing need to train apprentices.

Figure A.4: Total operating and maintenance expenditure,^a industry aggregate, out-turn operating and maintenance expenditure 2001-04 and Commission Final Decision 2006-10, \$million, real \$2004



^a Exclusive of operating and maintenance expenditure associated with prescribed metering services.

Forecast revenue requirement

In addition to the operating and capital expenditure forecasts established, the building blocks approach adopted for this price review includes allowances for:

- return on capital, comprising a market-based estimate of the weighted average cost of capital applied to a regulatory asset base that incorporates new net capital expenditure less allowed depreciation and disposals over the previous regulatory period;
- an efficiency carryover allowance that extends the reward for out-performance against the capital and operating expenditure benchmarks established at the last review; and
- depreciation and corporate taxation payments.

To determine the return on capital component of the revenue requirement, the Commission has applied a real after-tax weighted average cost of capital of 5.9 per cent to the rolled forward values of the regulatory asset base. The change in the weighted average cost of capital from that used in the last price review is due principally to the decline in long term

real interest rates which, for ten year CPI-linked Commonwealth government bonds, from 3.5 to 2.64 per cent.¹⁰ The building blocks described above have then been aggregated to establish forecast revenue requirements for each of the distributors over the five year period of this review. These revenue requirements are set out in Table A.1.

From 1 January 2006, prescribed metering services will be regulated under a separate price control mechanism from distribution use of system services. In this Decision, the Commission has determined a separate revenue requirement and price control for the regulation of these services which includes the expenditure associated with rolling out interval meters. This revenue requirement has been developed using the Commission's building blocks approach and is then translated into a set of prescribed metering charges using forecasts of growth over the period.

Table A.1: Building blocks revenue requirement, 2006-10, \$million, real \$2004

Distributor		2006	2007	2008	2009	2010
AGLE	DUoS	129.7	123.2	127.3	135.0	132.5
	Metering	5.1	6.9	8.7	10.6	12.3
	Total	134.8	130.1	136.0	145.6	144.8
CitiPower	DUoS	182.7	171.3	160.1	161.1	169.4
	Metering	4.6	7.2	9.7	11.6	13.4
	Total	187.2	178.5	169.8	172.6	182.8
Powercor	DUoS	320.0	326.0	331.7	340.2	348.0
	Metering	14.3	18.8	24.5	29.9	35.1
	Total	334.3	344.8	356.1	370.1	383.1
SP AusNet	DUoS	289.7	279.5	290.8	289.3	307.6
	Metering	18.0	20.5	25.6	30.2	34.6
	Total	307.7	300.1	316.4	319.4	342.2
United Energy	DUoS	271.7	251.9	257.0	243.5	230.2
	Metering	7.9	10.5	14.5	18.0	20.9
	Total	279.6	262.5	271.5	261.5	251.2

Looking ahead, the experience from the 2001-05 regulatory period highlights the difficulties in distinguishing enduring efficiency gains in implementing capital expenditure programs (such as would arise from establishing more efficient capital expenditure project management arrangements) from temporary efficiency gains (such as arise from the deferral of planned expenditure that does not threaten service performance).

¹⁰ These rates are based on the last 20 trading days to 31 July 2005.

For the 2006-10 regulatory period, the Commission has removed the additional payment for capital expenditure efficiencies although the efficiency carryover mechanism will continue with respect to operating and maintenance expenditure. One ancillary benefit of this change is that any network investment required in addition to the forecast will not attract a penalty. When combined with the revised service incentive scheme, the Commission expects that the distributors will actively pursue further capital investment where this delivers improvements in services.

Real price reductions

The revenue requirements outlined earlier have been developed having regard to forecasts of growth in customer numbers, peak demand and energy delivered so as to develop a set of price controls that, when applied to existing prices, will deliver expected revenue over the following five years that is equal in net present value terms to the revenue requirement determined by the Commission.

The combination of favourable capital market conditions, efficiencies achieved in the current period, and the expectation of growth in customer numbers and energy delivered means that these revenues can be recovered at prices lower than those applying in the current period.

The benefits that flowed to the distributors over the current period are being returned to customers to ensure that customers share in the benefits of these efficiency gains as intended by the Commission’s regulatory framework and as is required by the Tariff Order’s requirements for a fair sharing of efficiency gains. These price reductions will manifest through initial larger reductions followed by ongoing smaller real reductions as set out in Table A.2.

Table A.2: P₀ and X-factors — prescribed services, 2006-10, per cent

	Prescribed services (DUoS and Metering)		Prescribed services (DUoS)	
	P ₀	X ₁ -X ₄	P ₀	X ₁ -X ₄
AGLE	3.1	1.2	3.8	2.5
CitiPower	7.7	1.5	8.7	2.5
Powercor	16.4	1.1	17.3	2.5
SP AusNet	7.8	0.8	9.3	2.5
United Energy	15.6	1.4	14.7	2.5

Consultation process

The Commission has engaged in an extensive process of consultation with distributors, customer groups and other industry stakeholders in reaching this Final Decision. It has also sought expert advice on the forecasting of demand, on the review of the distributors' expenditure proposals, and on a range of economic and legal issues more generally. In summary, the process has involved:

- consultation on the framework and approach for the review, over an extended period beginning in March 2004;
- the submission by distributors of comprehensive price-service proposals in October 2004;
- several consultation papers and workshops;
- the review by independent consultants of the distributors' growth forecasts and expenditure proposals;
- numerous requests for further clarifying information;
- the publication in March 2005 of a Position Paper which set out the Commission's preliminary thinking on a range of key issues for the review and submissions from stakeholders to the Position Paper;
- the Draft Decision and extensive submissions by the distributors and other stakeholders in relation to the Draft Decision; and
- this Determination.

Issues arising from the review

Whilst there has been a marked improvement in the service performance of electricity distributors since the industry was restructured in 1995, the role of economic regulation in guiding further improvements has never been more important. The privatisation of an industry that displays monopoly characteristics will often give rise to tensions between a firm seeking to maximise returns to shareholders and the expectations and objectives of customers. The task of economic regulation is therefore to design incentives that align the commercial interests of the distributors with the interests of society at large, namely securing a reliable supply at an optimal price and quality.

However, regulators must overcome a number of not insubstantial hurdles when implementing effective regulatory controls. The most notable of these relates to the information asymmetry that exists between the regulator and the utility. The combination of the reliance on the information provided by the utility and a focus on shareholder value means that utilities have a clear incentive to "talk up" the future operating cost and

investment requirements of their networks and to “talk down” their future sales potential, in order to secure more generous price controls. Designing and managing regulatory processes that recognise these incentives and address the asymmetry of information is a well recognised and fundamental challenge for monopoly infrastructure regulators.

The regulatory controls that were introduced by the Office of the Regulator-General in 2001 were specifically designed to address these hurdles. The implementation of a building block revenue requirement along with an efficiency carryover mechanism was designed to provide distributors with an incentive to reveal their efficient costs over the course of the first regulatory period.

The central proposition of the framework was that under-spending against the expenditure benchmarks would be rewarded equally irrespective of the year in which the under-spending occurred. Under this framework it was assumed that the distributors would have a reduced incentive to defer efficiency improvements or allow expenditure to increase towards the end of one regulatory period so as to obtain more generous expenditure forecasts in the following regulatory period. Given this, it was expected that revealed costs from the first regulatory period could be given greater weight in establishing efficient expenditure forecasts for the next regulatory period. In hindsight the Commission underestimated the challenges that would present themselves in relying on the reported costs of the distribution businesses.

One of the main factors complicating the Commission’s task has been the considerable restructuring of the distribution businesses since the implementation of the current price controls, including arrangements entered into by the distributors with entities with common ownership that are not directly covered by the regulatory regime.

In the period since the last review, many of the distributors have entered into or extended existing arrangements under which other parties provide services to the legal entity responsible for distribution services under the Distribution Licence. Where there is an incentive to enter into an arrangement that is not arm’s length, the potential effect of such arrangements is to inflate or obscure the reported costs of the distributor.

Outsourcing arrangements, multi jurisdictional operations and other integrated organisational arrangements have accentuated the challenges with respect to obtaining transparent cost data and unravelling complex and changing cost allocations. This has raised issues in reconciling historic information with current forecasts and therefore the ability to determine reasonable forecasts and the efficiencies to be shared with customers.

Throughout the price review the Commission faced considerable difficulties with obtaining information to enable a proper assessment to be made of the costs incurred in providing distribution services. In some instances the difficulties were confined to delays, whilst in others the information was withheld entirely. In one instance, where information was not voluntarily provided by a significant service provider to a licensed distributor, the Commission issued notices under section 37 of the *Essential Services Act 2001*. The notices

were subsequently appealed on the grounds that they were not made in accordance with the law and were unreasonable. The Appeal Panel upheld the appeal in part on the basis that the period of time within which the service provider was required to provide the documents and information specified in the notices was not sufficiently long. This was in spite of the fact that the information had been sought over a long period of time.

Although the Appeal has highlighted aspects of the law which will require clarification, and some procedural improvements which will need to be made in relation to the issue of section 37 notices, the Appeal Panel clearly accepted that the Commission could serve such a notice on parties other than regulated distributors and that the Commission did have the power to obtain the details of industry costs from sub contractors.

The entry by distributors into outsourcing arrangements, particularly where those outsourcing arrangements have not or are not capable of being appropriately market-tested, and the regulatory treatment of such outsourcing arrangements, is an issue that has been the subject of much consideration by the Commission. In this, the Commission is not alone — regulators in other industries and jurisdictions face similar challenges. However, it is critical to the integrity of the regulatory framework that regulators are able to investigate these arrangements and ensure that their existence does not prejudice the delivery of the benefits to customers under the regulatory framework.

As a result of the difficulty that the Commission has had in obtaining information on the costs of providing distribution services from at least some of the distributors, the Commission has been forced to either directly estimate relevant out-turn costs or make a number of adjustments to the information reported to derive their relevant costs for the 2001-04 period. The necessity for such adjustments arises in the context of all forms of monopoly regulation that rely on business-specific cost information, because of the associated incentive to report or represent costs as being greater than they are. This is particularly the case where the benefits of efficiencies are required to be shared between distributors and customers, in which case there is a greater incentive for a distributor to enter into arrangements or adopt practices that distort the sharing of the benefits.

Whilst the Commission is satisfied that the expenditure allowances which it has made are more than sufficient for the distributors to meet their obligations and future investment needs, the Commission notes that an approach that relies on adjustments to reported expenditure may not be sustainable over the longer term.

Looking ahead

An important backdrop to this review is the planned transfer of responsibility for rule making and for regulation of energy distribution businesses to the new national framework for regulation of energy markets, administered by the Australian Energy Market Commission (AEMC) and the Australian Energy Regulator (AER). Although the detailed transition path is

still to be finalised, the working presumption is that the price controls applying to Victorian electricity distributors from 2011 will be determined by the AER, under a framework of rules to be reviewed and implemented by the AEMC. It is inevitable that this framework will involve some change to the legal and regulatory environment that governs this review.

The Commission believes it important to note that its approach to this review has not been altered by the prospect of change that the new national framework involves. Rather, the Commission has approached this review, first, by applying the existing legal framework as it best sees fit and, second, by articulating the principles it has applied and the facts it has considered as clearly as possible. In the Commission's view, this not only represents good regulatory practice, but it also means that, once the transfer of responsibilities does take place, it will be relatively easy for the AER to understand what was done and why, and for the appropriate transition arrangements to be put in place.

Over the past year or more, the Commission has also sought to invigorate debate on the potential for greater use of index-based approaches to regulating monopoly services, including electricity distribution. The Commission's principal motivation for this work is to seek refinements that can improve both the process and the incentives arising in the conduct of regulatory reviews. The Commission is particularly interested in regulatory approaches that either reduce or eliminate the role of forecasts in regulatory reviews as well as the role played by company specific reported costs in determining efficiency outcomes, both of which give rise to regulatory burdens and distorted incentives.

To this end the Commission has published a major report investigating and comparing the incentive power of alternative regulatory regimes (PEG 2005b). The combination of positive stakeholder responses, conclusions from the incentive power work and the continuing challenge of determining forward looking building blocks in the face of strong information asymmetries, has strengthened the Commission's resolve to make progress in this area.

The Commission recognises that further work and consultation is essential to ensure that an indexed-based approach to regulation can be established as a viable option for determining price controls from 2011. Irrespective of which regulatory body is responsible for taking forward the regulation of Victorian and other electricity distributors, it will remain an inescapable challenge for the economic regulation of long lived infrastructure assets to provide the optimum incentives for efficient asset management and investment while also delivering appropriate price-service outcomes for customers.

Although there is considerable debate over how company specific cost data is used in regulation the ability for a regulator to have access to, and rely on, reliable, consistent and robust information on the provision of regulated services is critical to the effective implementation of all forms of regulation, including indexing and price monitoring.