APPLICATION BY POWERCOR FOR A LICENCE TO DISTRIBUTE ELECTRICITY IN THE DOCKLANDS

FINAL DECISION

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1st floor, 35 Spring St, Melbourne 3000
Telephone: (+61 3) 9651 0222 *Facsimile:* (+61 3) 9651 3688
Email: reception@reggen.vic.gov.au
Web site: http://reggen.vic.gov.au

PREFACE

As a consequence of winning the tender to provide trunk services in the Melbourne Docklands, Powercor Australia Ltd (Powercor) applied to the Office of the Regulator-General (the Office) for a variation to its distribution licence in March 1998. Subsequently, in December 1998, Powercor also applied for a separate distribution licence to cover the same area. While CitiPower Pty (CitiPower) is currently the only company licensed to distribute electricity in the area, these two applications by Powercor are for Powercor to be allowed to offer electricity distribution services in the Docklands in addition to CitiPower.

The Office's role was to decide whether to grant either of the two applications and, if so, the terms and conditions governing the relevant licence.

Sections 161 to 164A of the *Electricity Industry Act 1993* provide the framework for these applications and the Office's decision. In deciding whether to grant Powercor a licence, the Office has also to be guided by its objectives in Section 157 of the *Electricity Industry Act* as well as Section 7 of the *Office of the Regulator-General Act 1994*.

To assist the Office in making a decision a *Discussion Paper* was published in June 1998. Submissions were sought from all interested parties and Powercor was given the opportunity to respond to these submissions. The Office also held extensive discussions with Powercor, CitiPower and the Docklands Authority to gain an understanding of the environment and the issues involved. Other interested parties also made representations to the Office, including other electricity distribution businesses, customers and property developers. In April 1999, to obtain public views on some of the issues that the Office was considering, a *Pre-Decision Consultation Paper* was published. Submissions were again sought from all interested parties.

The Office released a *Draft Decision* on the applications in June 1999 and again sought submissions from interested parties. Most of the submissions received by the Office in response to all of these papers have been placed on the Office's web site.

This *Final Decision* affirms the Office's intention described in the *Draft Decision* to grant Powercor a licence to distribute electricity in the Docklands. This implies that both CitiPower and Powercor will be licensed to distribute electricity within the Docklands. The *Final Decision* has also affirmed the Office's intention to describe the future regulatory treatment of distribution investment within the Docklands (for *all* potential distribution licensees) to ensure that the process by which distribution licensee are selected for the precincts is directed towards the selection of the *lowest cost* provider of distribution services. This *Final Decision* reflects the Office's analysis of the issues involved and the submissions provided by interested parties against the relevant statutory requirements.

[signed by JOHN C TAMBLYN]

JOHN C TAMBLYN
Regulator-General

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EXECUTIVE SUMMARY

In response to Powercor's applications for a licence or licence variation giving it the right to distribute electricity in the Docklands, the Office was required to decide whether such a licence right should be granted and, if so, on what terms and conditions. A decision to grant a licence or licence variation to Powercor would allow it to provide distribution services in the Docklands in competition with the incumbent licensee, CitiPower.

After conducting extensive discussions with interested parties including Powercor, CitiPower and the Docklands Authority, and having taken into account all of the submissions provided to it, the Office has decided to issue Powercor with a licence that will permit it to distribute electricity within the Docklands area. This licence will allow Powercor to provide electricity distribution services to the Docklands by means of the *trunk infrastructure* it is providing with Transfield under contract to the Docklands Authority and within the Docklands by means of any assets within the Docklands over which Powercor obtains control.

Decision framework and criteria

In performing its electricity regulation role, the Office is required to consider a number of (potentially inconsistent) statutory objectives, including promoting economic efficiency, competition, financial viability and the interests of electricity consumers. Reflecting on those objectives as a whole, the Office considers that its primary objective should be to advance the long-term interests of electricity customers by promoting economic efficiency, financial viability and effective competition in the electricity industry.

Accordingly, in reaching its decision on Powercor’s licence applications, the Office has focused on developing a framework that is best likely to promote the long-term interests of final users of electricity in both the Docklands and in Victoria more generally. While the ‘interests of end-users’ has a number of different facets, the Office considers that the interests of electricity customers as a whole will be advanced most effectively by promoting economically efficient network service outcomes.

In markets that are characterised by effective competition, that competition provides market participants with a strong incentive to act in a manner that is consistent with economically efficient outcomes and with serving the interests of consumers. In contrast, in markets where competition is weak or absent, those incentives no longer exist and regulatory intervention can be justified in order to promote efficiency and the interests of consumers. While many different forms of intervention are possible, the Office considers that it should seek to emulate competitive market outcomes by adopting regulatory arrangements that give market participants incentives to act in ways that are consistent with achieving efficient network outcomes and customer benefits.

Summary of reasons

Having considered all of the issues, information and views put to it during this inquiry, the Office has concluded that the introduction of network contestability between two or more licensees authorised to supply network services to the

Docklands will provide commercial incentives for efficiency improvements and customer benefits that would not otherwise be available.

However, the Office maintains the view that whichever distribution businesses become the service providers in precincts of the Docklands, they are likely to be in a position to exercise substantial market power once they have obtained ownership or control of relevant distribution assets. This is because the supply of distribution services is characterised by strong economies of scale and scope and a high proportion of sunk costs; features that are normally associated with natural monopoly and an absence of competitive entry.

The Office therefore considers that some form of ongoing regulation will be required to encourage efficient provision and pricing of distribution services in the Docklands. However, as noted above, it believes such regulation should seek to emulate the incentives and outcomes of competitive markets to the greatest extent possible. In markets such as the Docklands, where there is likely to be little or no ongoing competition, the potential for effective competition may exist for a period of time, or for some components of the service. Mechanisms that harness this competitive potential can provide a powerful tool for aligning the incentives of market participants with efficient outcomes which advance the interests of customers.

The Office had this objective in mind in deciding to issue a licence to Powercor to enable it to compete with CitiPower for the right to supply distribution services in the Docklands.

In deciding to issue Powercor with a licence to provide distribution services in the Docklands, the Office concluded that, on balance, the interests of end-users are likely to be promoted best by allowing Powercor to operate the Docklands electricity trunk infrastructure which it is constructing with Transfield and to operate any other assets in the Docklands precincts over which it obtains control. While this may involve some duplication of service potential, the Office has concluded that the availability of the Powercor trunk as an alternative to CitiPower's trunk assets will enhance competition for the provision of distribution assets within the Docklands precincts, thereby providing benefits which outweigh the costs.

Although there are indications that the Powercor trunk assets may not be able to access economies of scale and scope to the same extent as the CitiPower trunk assets, the availability of a choice of trunk infrastructure connections to the precincts is expected to create competitive pressures which should enhance efficiency in the design, installation and operation of the intra-precinct distribution assets. Because the total cost of the intra-precinct assets will exceed substantially the (relatively modest) cost of the trunk assets, the net benefits for electricity customers resulting from this trunk infrastructure competition are expected to exceed substantially those that would be available in its absence.

The Office's decision to license Powercor to provide distribution services in the Docklands should not be interpreted as providing any warranty as to the technical merits of the Powercor trunk assets. Under its licence obligations, Powercor is responsible for the design, installation and operation of a trunk infrastructure system which provides efficient and reliable services to the Docklands precincts. The Office

will monitor the performance of the Docklands distribution networks against these licence requirements.

Although the Office considers that introducing a measure of network contestability by licensing Powercor can provide net benefits for customers, it does not believe it would be appropriate to leave the selection of the Docklands distribution licensee to the 'market' (ie to the Docklands developers) without further regulatory guidance.

The *Final Decision* identifies a number of reasons why an unregulated selection process is unlikely to result in the selection of the most efficient operator or to promote the best interests of electricity customers. It also examines alternative options for promoting effective competition between licensees in the Docklands while keeping regulatory intervention to the minimum consistent with promoting efficiency and the interests of customers.

In the *Pre-Decision Consultation Paper* the Office examined an alternative mechanism - franchise bidding - for selecting the distribution licensee to supply services within the Docklands precincts. This approach would make use of the competition that exists for a market prior to assets being installed. The Office remains of the view that this may be an appropriate competitive mechanism for determining future price and service levels for the services provided by means of network assets with natural monopoly features. However, in response to practical concerns raised regarding the use of franchise bidding to select distribution licensees for the Docklands precincts, the Office has decided not to proceed with that mechanism in this instance.

As an alternative, the Office has decided to adopt a simple regulatory rule that it considers will provide Docklands developers with a strong commercial incentive to select the most efficient distribution licensee and network configuration for the supply of distribution services to the Docklands precincts. The essence of this rule is that the Office will regulate prices for the supply of distribution services within the precincts and in doing so the distribution assets downstream of the trunk assets will be deemed to have a regulatory value of zero.

A consequence of this rule is that developers will be required to fund these assets and recover the cost in the prices of the developed properties. This direct financial involvement should, in turn, give developers the incentive to select the most efficient provider of distribution assets and services in the Docklands precincts. Accordingly, the rule will permit the Office to leave the detailed assessment of who is likely to be the most efficient provider in the Docklands to those in the best position – the developers and potential suppliers of distribution services.

The Office intends to adopt this simple regulatory rule when determining the price controls for the relevant Docklands licensees in the 2001-5 electricity distribution price review currently being undertaken by the Office.

Some submissions questioned the proposal in the *Draft Decision* to regulate the Docklands area separately from the existing distribution systems. The Office has given weight to these concerns and has decided that Powercor's activities within the Docklands should be regulated under the price controls that apply to Powercor's existing regulated wires business. This would imply that Powercor's expenditure and

revenue within the Docklands area would be considered when determining price controls at each periodic review. Powercor would be permitted to charge its relevant standard tariffs within the Docklands, or to set new distribution tariffs specific to the Docklands infrastructure, within the constraints of the relevant price control and any applicable re-balancing restriction.

Similarly, as the Docklands is within CitiPower's existing licence area, its distribution activities within the Docklands would be covered by the current and future price controls and related regulatory measures that are applicable to its network as a whole.

The Office's Final Decision

The Office has decided to issue a new licence to Powercor to enable Powercor to provide electricity distribution services within the Docklands area. The Office will ensure that the regulatory regime (including the existing price control) that applies to Powercor's existing regulated business would apply to any electricity distribution business it undertakes within the Docklands.

While the Office reserves the right to vary the methodology ultimately used to determine relevant tariffs as part of the next or any subsequent electricity distribution price review, the Office intends to deem a regulatory asset value of zero for any non-trunk assets that are installed within the Docklands precincts by any distribution licensee.

The Office's proposed definition for distinguishing between trunk and non-trunk assets is provided in section 6.4.2. As discussed in that section, the Office invites comments from interested parties on that definition by 26 October 1999. Having considered any comments, the Office will implement its final definition of trunk/non-trunk assets through an appropriate change to the regulatory accounting guidelines and its requirements for the 2001-5 distribution price review.

The Office will apply the minimum reliability benchmarks foreshadowed in section 6.4.1 when assessing the reliability targets proposed by the licensees and the actual performance of the licensees in the provision of distribution services within the Docklands.

The performance of Powercor's Docklands assets will be regulated under the performance monitoring regime that applies generally to the Victorian electricity distribution licensees. Powercor will be responsible for designing, installing and operating infrastructure that provides efficient and reliable distribution services to the Docklands precincts it serves. The Office will monitor and report on the performance of the distribution networks, take remedial action should the performance provided not meet the licence requirements and allow recovery of costs efficiently incurred in providing distribution services.

1. INTRODUCTION AND PROCESS UNDERTAKEN BY THE OFFICE

Powercor Australia Ltd (Powercor) currently holds an electricity distribution licence that permits it to distribute electricity in the western half of Victoria. On 4 March 1998 Powercor applied to the Office of the Regulator-General (the Office), pursuant to section 164(1)(b) of the *Electricity Industry Act 1993*, for a variation to its distribution licence to enable it to distribute electricity in the Melbourne Docklands. Subsequently, in December 1998, Powercor submitted a further application for it to be issued with a new licence to permit it to provide electricity distribution services in the Docklands. The two applications cover the same area and the same proposed network system.

This *Final Decision* applies to both Powercor's applications - for a licence variation as well as for a separate licence to distribute electricity in the Melbourne Docklands.

The applications are for what has sometimes been termed an inset appointment. This is a licence granted to a business to distribute power to an area that lies within the boundaries of the licensed area of another business. The Docklands lies within the area covered by CitiPower's licence. Powercor has not sought exclusive rights to supply the Docklands so that the application, if granted, raises the prospect of more than one firm having the right to distribute electricity in this area. This may have implications for competition, efficiency, consumer protection and industry viability - matters that the Office is required to have regard to in performing its functions.

The applications are the first of their kind that the Office has had to consider. Because the issues they raise are profound and may emerge in other contexts in the electricity and other regulated network industries, including gas and water, the Office considered it necessary to examine the general competition and regulatory issues as well as the specific matters raised by these applications.

The applications were advertised in newspapers and public submissions on them were sought. The Office published a *Discussion Paper*, a *Pre-Decision Consultation Paper*, and on 9 June 1999 the Office released a *Draft Decision* in relation to the applications. All of these documents were made widely available and included on the Office's web site, and submissions from all interested parties were sought on each of these papers. Extensive discussions were held with Powercor, CitiPower and the Docklands Authority (the Authority) with their developers. Both Powercor and CitiPower were given opportunities to respond to the submissions provided by each other and by other parties. The Office appointed a technical consultant[1] to assess issues raised by the parties in relation to the development of the electricity network in the Docklands area and a site visit was made. The Office also took into consideration relevant experience in other jurisdictions and in other network industries in arriving at this *Final Decision*.

2. BACKGROUND TO THE APPLICATION

In November 1996 the Authority invited Expressions of Interest from infrastructure providers, construction organisations, investors, financiers and other interested parties to bid for the right to provide trunk infrastructure to the Docklands. Powercor entered

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[1] Connell Wagner.

a consortium with Transfield Pty Ltd and Transfield Holdings Pty Ltd to provide this infrastructure and its tender was announced as being successful in February 1998. The tender covered the provision of infrastructure for roads, pedestrian links, utilities including water, drainage, sewerage, electricity, gas and telecommunications, removal of some railway equipment and some landscaping works. Hence, electricity infrastructure formed only a part of the tender. The price that was bid by the Transfield/Powercor consortium for providing this infrastructure was $71 million. Powercor has stated to the Office that the cost of the electricity infrastructure was not included in this bid, as it expected to be able to recover this cost from consumers of electricity in the future.

The Docklands covers an area of over 200 hectares adjoining the Melbourne Central Business District (CBD), the Port of Melbourne, the Yarra River and the Spencer Street Railway Station. The area has been designated for extensive new development under the control of the Docklands Authority. Development is likely to accelerate over the next few years, and the initial build-up will occur over the next 10-15 years. The area currently has seven different precincts comprising Business Park (approximately 36.2 hectares); Victoria Harbour (approximately 30.2 hectares); Yarra Waters (approximately 14.5 hectares); Batman's Hill (approximately 14.6 hectares); Technology Park (approximately 6.8 hectares); Stadium Precinct (approximately 13.2 hectares) and West End (approximately 25 hectares).

Trunk infrastructure essentially covers the infrastructure that brings services to the boundary of the individual development precincts. As part of the winning consortium, Powercor's responsibility is to ensure that power is made available when required by the Authority. Powercor could meet its obligation by designing and constructing the necessary works itself or by arranging for some other organisation or organisations to do this on its behalf. It is important to note that the trunk infrastructure will only account for a relatively minor share of the total cost of electricity distribution assets that will be required to provide electricity distribution services in the Docklands precincts. It is understood that there has not been a process as yet to award the right to provide distribution assets for any of the Docklands precincts, apart from the Colonial Stadium (which will be supplied by CitiPower).

CitiPower currently has extensive electricity distribution infrastructure near the boundaries of the Docklands and has provided the required infrastructure within the Docklands to date, essentially by augmenting and extending its existing network. CitiPower also bid for the rights to provide the trunk infrastructure to the Docklands with another consortium, but that consortium was unsuccessful.

Powercor's proposal is to construct a 22 kV link into the Docklands from GPU PowerNet's Fisherman's Bend Terminal Station (FBTS), which is outside the Docklands. The Office understands that design and construction of the trunk infrastructure has commenced although orders have not yet been placed for major plant items pending this *Decision*. Conduits are being installed for later installation of cable (which will also house telecommunications facilities).

Whilst Powercor has been selected by the Docklands Authority to provide the trunk infrastructure, it will not be able to distribute electricity in the area unless it first obtains a licence. Only CitiPower currently has a licence to supply into the area. Powercor's applications to be licensed to distribute electricity in the area would, if

granted in the form applied for, allow the company to distribute electricity to the precincts and also within the precincts.

3. THE REGULATORY FRAMEWORK FOR ELECTRICITY DISTRIBUTION

3.1 Regulation of Distribution and Retail Licensees

The *Electricity Industry Act 1993* establishes a licensing system to cover the distribution of electricity in Victoria. Licensees are required to have the technical capacity to be able to operate in the industry and licences can be subject to terms and conditions as decided by the Office. To date, distribution licences have been issued to five regionally based distribution companies, including Powercor in the western part of the State and CitiPower in Central Metropolitan Melbourne, which covers the Docklands.

The licences, amongst other things, give effect to a third party access regime for the distribution systems. The licences require the distribution licensees to permit customers (and retailers on their behalf) and embedded generators to connect to and use their distribution system.[2] In addition, the distribution licensees are required to permit other distribution licensees to interconnect with their system and to provide services to the other licensee that facilitate the distribution of electricity, as well as permitting the other licensee to use its facilities (such as conduits, poles and communications lines). The licences require any offer and the continued supply of these services to be on terms and conditions that are 'fair and reasonable' and consistent with guidelines issued by the Office.

The *Tariff Order* is the major regulatory instrument dealing with the pricing of distribution services. It breaks the regulated services into two classes – the 'standard' distribution services (referred to as tariffed distribution services) and 'non-standard' distribution services (referred to as excluded services).[3]

For the 'standard' services, the *Tariff Order* adopts a 'revenue yield' regulatory regime. Under this regime, the weighted average of all distribution charges in a given year is not permitted to exceed a maximum average charge, which is escalated by inflation less an offset (X) in each year. This provides the distribution licensees with some flexibility to change the *relative charges* for different customer classes (known as 're-balancing'). However, the *Tariff Order* also places restrictions upon the extent of this re-balancing by limiting the extent to which any individual charge may be increased (the average network tariff for a customer class is precluded from rising in any year by more than the rate of inflation plus two percent).

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[2] The mechanics of this are that the customer, retailer or embedded generator first has to request connection, and then the distribution licensee is required to make an offer to provide the relevant service or services, including a statement of the applicable terms and conditions. There are timelines specified that govern the offer by the distribution licensee to the access seeker.

[3] All of these other services are called 'excluded services' in the Tariff Order to reflect the fact that the regulation of these charges is undertaken separately to, or *excluded* from, the maximum average charge referred to below.

In relation to the 'non-standard' services, the *Tariff Order* repeats the provisions in the licences that state that these services must be supplied on terms and conditions that are 'fair and reasonable'. The Office has the power to decide the price and other terms and conditions for these services, if required. The Office also has the power to issue guidelines addressing the terms and conditions of supply of excluded services and to approve in advance the price for an excluded service as being fair and reasonable.

The licences contain a number of other provisions dealing with third party access issues. One such provision requires the distribution licensee to seek competitive tenders for augmentation works where those works are necessary to connect a customer (or retailer on its behalf), embedded generator or other distribution licensee to its system.

The *Electricity Industry Act* also establishes a licensing regime for the retailing of electricity in the State. All of the distribution licensees have their own retail arms (and hold licences). A total of 24 retail licences have been issued to date. The five electricity distribution/retail businesses have exclusive retail franchises over the non-contestable customers within their franchise areas and are required to sell electricity to these customers on terms that are consistent with the *Tariff Order*. The *Tariff Order* specifies a Maximum Uniform Tariff (MUT) that such customers can be charged for electricity. There is no regulation of the retail price of the contestable customers. Under the contestability timetable set out in the *Electricity Industry (Non-Franchise Customers) Regulations 1995*, all customers will be contestable by 1 January 2001 and the MUTs will be removed from that time.

At present, the licence areas for the distribution licensees do not overlap. However, there is nothing in the legislation and other regulatory instruments governing the Office's decision-making that expressly precludes the Office from issuing more than one distribution licence for a particular area.[4] Such a decision, however, would need to be consistent with the principles and objectives that it is required to have regard to when deciding on licence applications or variations. Accordingly, this framework is discussed next.

3.2 Legal Framework for New Licences or Licence Variations

Provided the Office is satisfied that a licence applicant is technically capable and incorporated in Victoria, section 162 of the *Electricity Industry Act* permits the Office to grant or to refuse an application for a distribution licence for any reason the Office considers is appropriate, having regard to the objectives specified in section 157 of the Act. In addition, as in all of its decisions, the Office is also required to take account of its objectives under sub-section 7(1) of the *Office of the Regulator-General Act 1994*. These sets of objectives are discussed below.

Section 163 of the *Electricity Industry Act* contemplates that new licences will be issued on terms and conditions, and a list of possible conditions is provided.

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[4] It is noted that CitiPower has contested whether the Office has the power to issue another distribution licence for the Docklands area.

In relation to a variation to an existing licence, section 164 of the *Electricity Industry Act* permits such a variation to occur through agreement between the Office and the distribution licensee.[5] The *Electricity Industry Act* does not require the Office to take *specific* matters into account in deciding whether to agree to a variation of a licence. In making this decision, however, the Office must comply with its obligation under sub-section 7(2) of the *Office of the Regulator-General Act* to exercise its powers in such a manner as the Office considers best achieves its objectives under the *Electricity Industry Act*. Again the Office is required to take into account its objectives under sub-section 7(1) of the *Office of the Regulator-General Act*.

Section 157 of the *Electricity Industry Act* describes the objectives of the Office under that Act, which are:

- to promote competition in the generation, supply and sale of electricity;
- to ensure the maintenance of an efficient and economic system for the generation, transmission, distribution, supply and sale of electricity;
- to protect the interests of consumers with respect to electricity prices and the safety, reliability and quality of electricity supply; and
- to facilitate the maintenance of a financially viable electricity supply industry.

There are likely to be situations where these objectives may not be consistent or compatible. As there is no priority between the objectives stated in the legislation, it is necessary for the Office to exercise judgement as to which should prevail in the event of any conflict between them and the balance that may need to be struck between them in the circumstances of particular cases.

As noted above, the Office is also required to take account of its objectives as specified in the *Office of the Regulator-General Act* when making any decision. These objectives, which are specified in sub-section 7(1) of that Act, are:

- to promote competitive market conduct;
- to prevent misuse of monopoly or market power;
- to facilitate entry into the relevant market;
- to facilitate efficiency in regulated industries; and
- to ensure that users and consumers benefit from competition and efficiency.

Again, no particular priority between these objectives is indicated by the legislation and, on the face of it, these objectives would not appear to be significantly different to those contained in the *Electricity Industry Act*. If there is any conflict between the objectives of the Acts, the objectives of the *Electricity Industry Act* are to take precedence.

Taken as a whole, the Office considers that a reasonable interpretation of its objectives is that the primary concern of the Office should be to promote the long-term interests of customers (end-users). This interpretation is consistent with

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[5] Section 164 of the *Electricity Industry Act* also permits a licence to be varied *without* the agreement of the distribution licensee provided that specified conditions are met. This power is not directly relevant to the applications by Powercor.

economic principles, accepted regulatory practice, and has been codified in some other regulatory regimes.[6] The specific objectives in the *Electricity Industry Act* and *Office of the Regulator-General Act* can then be interpreted as guiding the Office towards the mechanisms that may contribute to the long-term interests of end-users, and to the role that the Office should play in the electricity supply industry.[7] The guidance that can be derived from the specific objectives are as follows:

- *Economic efficiency*[8] – economic efficiency is consistent with the interests of customers *taken as a whole*. This is because improvements in economic efficiency imply that one or more customers can be made better off without making others worse off, and so distinguishes changes whereby a gain to one class of consumers comes at the expense of another class of customers.
- *Competition*[9] – where effective competition exists, it can be a powerful mechanism for aligning the incentives of suppliers and buyers of goods and services and for obtaining economically efficient outcomes. In these ways effective competition promotes the long-term interests of end-users. *Competition* also implies that customers have *choice*, which they might value independently of the price or quality of supply.
- *Protection of customers*[10] – in circumstances where competition is weak or absent, as is currently the case in the supply of many network services, regulation can be justified in order to ensure that the long-term interests of customers are promoted.
- *Facilitate the maintenance of a financially viable industry*[11] – it is in the interests of customers for an adequate supply of electricity, at an adequate quality, to be provided into the long-term. This in turn requires a commercial and market environment which continues to attract capital into the electricity supply industry and which provides incentives for efficient maintenance and operation of assets and infrastructure for the generation, transportation and supply of electricity. Such an environment provides efficiently financed and managed businesses with the opportunity to maintain their financial viability. The capacity of efficiently managed electricity businesses to maintain financial viability can be enhanced by promoting effective competition and through efficient regulation of network infrastructure services.

While the focus on the promotion of the long-term interests of end-users, and assessing the specific objectives against this goal, provides a logical and consistent

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6 The pursuance of the 'long-term interests of end-users' is the primary objective for both the Australian Competition and Consumer Commission and the Australian Communications Authority when making regulatory decisions for the telecommunications industry under Parts XIB and XIC of the *Trade Practices Act 1974* and the *Telecommunications Act 1996*.

7 In effect, the objective of promoting the long-term interests of end-users provides a logical and consistent method of weighting, and analysing the significance of, the information that is provided by considering the objectives separately.

8 Objective 2 of the EI Act, and objective 4 in the ORG Act.

9 Objective 1 of the EI Act and objective 1 of ORG Act. In relation to electricity distribution, while competition may not be a specific objective, the Office is permitted to have regard to competition if the Office considers that this is appropriate (*CitiPower Pty vs Office of the Regulator-General and Powercor Australia Ltd*, [1999] VSC 348.

10 Objective 3 of the EI Act and objectives 2 and 5 of the ORG Act.

11 Objective 4 of the EI Act.

criterion for decision-making, the Office also will have regard to the statutory objectives independent of their effect on the long-term interests of customers. In the current matter, however, the Office does not consider that any additional information is provided by considering the objectives separately. It has not been argued to the Office that a decision over whether or not to licence Powercor could affect the financial viability of the industry or firms within it. Rather, the arguments for or against the promotion of competition in relation to the Docklands distribution infrastructure have been argued by submitters in the context of the implications of that competition for efficiency and customer benefit.

Accordingly, in the current matter, the Office will use the promotion of the long-term interests of customers as the criterion for judging whether it should grant a licence to Powercor as requested. In addition, the Office will take the implications for economic efficiency as an important indicator of the long-term interests of end-users (the Office's interpretation of economic efficiency and the relationship between economic efficiency and customer benefit are discussed in detail in section 4.2.2). It should be emphasised, however, that while economic efficiency is useful as a *general indicator* of the interests of customers, there are other aspects to the interests of customers that will be relevant in particular matters.[12]

A significant factor in the current matter is the extent to which competition in the provision of electricity distribution services is likely to emerge, and so whether an attempt to facilitate competition is likely to be an appropriate tool for promoting (or is even consistent with) the long-term interests of customers. Accordingly, a discussion of how the long-term interests of customers is to be interpreted and the role that competition may play in that context is presented next.

4. REGULATORY POLICY ISSUES

4.1 General Position of the Office on Inset Licensing Issues

A number of the submissions suggested that the Office should develop general principles for the assessment of all inset licensing applications rather than making a decision specifically for the Powercor licence applications. The Office also noted the desirability of establishing general principles in the *Discussion Paper* that was released in July 1998. The former Energy Projects Division, in a submission to the Office also urged the Office '*to develop a clear set of guidelines to achieve efficient outcomes through contestability*' for the provision of new distribution services.

On further consideration, however, the Office has decided not to advance *general* principles applicable to all inset licence applications at this stage for the following reasons.

First, as discussed in detail below, the Office has reached the view that *unmanaged* 'competition' for the right to be the supplier of electricity distribution services in the Docklands is unlikely to be in the long-term interests of end-users. It is concluded, however, that it may be possible to establish a framework of incentives to align

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[12] For example, how the burden of the recovery of costs is distributed between customer classes is a matter that the Office, in having regard to its statutory objectives as discussed above, would need to take into account where relevant.

competition with the interests of end-users, and a framework the Office considers should meet this objective is described in this *Final Decision*. It is noted, however, that other frameworks exist that might be preferable in other circumstances, the most important of which is the 'franchise bidding' approach that is described in section 4.4 below. The Office would like to assess further the feasibility of the 'franchise bidding' approach prior to developing any general approach to inset licensing issues.

Secondly, many of the comments about the desirability or otherwise of inset licensing (or, more relevantly in some cases, by-pass) reflect the market pressures that the existing tariff structures of the distribution licensees might create. However, in *2001 Price Review: Guidelines for the Preparation of Price Review Submissions*, the Office has invited distribution licensees to test their existing tariffs against the 'economic efficiency criteria' (described in section 4.2.2 below), and to propose a strategy for adjusting tariffs where these criteria are not met that has careful regard to customer impacts. The Office considers that, if it is possible for the distribution licensees to adjust tariffs that do not meet the economic efficiency criteria, then much of the market pressure for inset licensing (or by-pass) should abate. Accordingly, the Office considers that the development of any general principles should await the outcome of the 2001 price review.

Finally, a number of features of the Docklands development distinguish it from typical inset developments. For example, the future electricity demand for the Docklands is difficult to forecast as the development will be completed over a period of 10 – 15 years. Also, the projected Docklands market has features that are similar to a central business district and the role of the Docklands Authority (in relation to tendering and developer oversight) is similar to that of a City Council. These somewhat unique features of the development raise different issues and may require different regulatory approaches than those appropriate to a more typical greenfields inset proposal.

4.2 Overview of the Issues

4.2.1 Significance of Issuing a Licence or Licence Variation

The decision to be made by the Office was whether or not (and upon what terms) Powercor should be granted a new licence, or a licence variation, to permit it to distribute electricity in the Docklands area. If the decision was made to grant the licence or licence variation as requested, then Powercor would be permitted to distribute electricity through the trunk infrastructure that it is in the process of constructing, subject to any terms and conditions imposed in the licence by the Office. In addition, Powercor would be permitted to distribute electricity within the precincts via any distribution infrastructure that passes under its control in the future, again subject to any terms and conditions imposed in the licence by the Office.

In considering whether or not Powercor should be granted such a licence, it has been necessary for the Office to assess the implications for the distribution of electricity both within and around the Docklands, that may flow from the decision on whether to issue the licence. At present, there is only one party that is licensed to distribute electricity in the Docklands, CitiPower. However, as noted in section 3.1, the Office considers that there is no legal obstacle to a decision by the Office to issue a licence to

another party (eg Powercor) to provide electricity distribution services in the Docklands.

Accordingly, the major issue for the Office is whether permitting an alternative distributor – Powercor – to provide electricity distribution services in the Docklands is more likely to promote or detract from the long-term interests of end-users. If allowing the possibility of a choice of electricity distributors is considered, of itself, unlikely to promote the long-term interests of end-users, then a related issue is whether it may be possible to specify some form of regulatory framework that would encourage the choice of electricity distribution licensees to be in the long-term interests of end-users.

Whether the choice of distribution businesses in the Docklands is likely to be in the long-term interests of end-users depends, in turn, upon the view that is taken about the prospect for ongoing competition for the supply of electricity distribution services in the Docklands after the control of the distribution assets passes to one or other of the licensed distributors. The Office's view on this matter is discussed in section 4.3. First, however, the concept of economic efficiency – which the Office will take as a primary indicator of the long-term interests of end-users – is discussed.

4.2.2 Conditions for Economic Efficiency

Economic Efficiency as a Guide to Consumer Benefit

The allocation of resources within an economic system is said to be *economically efficient* if it is impossible to change production practices, the mix of goods and services produced, or to trade goods between end-users in such a way that makes one consumer *better off* without making any other consumer *worse off*. It follows that wherever resources are not allocated efficiently then, in principle, the removal of that inefficiency could result in one or more consumers being made better off without making any consumer worse off. Accordingly, adopting economic efficiency as the key criterion for decision making is equivalent to ensuring that the interests of end-users *as a group* should be maximised.

That said, however, some efficiency improving measures might lead to an uneven sharing of the gains, and possibly lead to some classes of end-users being made worse off as a result. As the Office does not have the necessary responsibilities or powers (or the information) to alleviate such effects, on occasions it may need to make decisions which strike a balance between the efficiency objective and other objectives, such as equity between end-users. In general, however, the pursuit of *economic efficiency* can be regarded as being consistent with promoting the long-term interests of end-users as a whole.

Efficiency Conditions

Three conditions for the achievement of economic efficiency can generally be distinguished.

The first condition is cost efficiency or *productive efficiency*. This requires that the service be provided at the lowest cost (to society as a whole) amongst the possible alternative suppliers and technologies. Where a service is provided by means of a

network that exhibits *economies of scale and scope*, this criterion requires that the design of the network be such as to realise those economies.

The second condition is *allocative efficiency*. This requires the price paid by a customer for a service to reflect the cost incurred by society in making the service available. This in turn encourages individuals to make efficient choices in their own decision-making (for example, in deciding between using electricity or gas, to choose the energy source that creates the lowest cost to society). The general condition for allocative efficiency is for prices to reflect the *marginal cost* of providing the service. However, where the provision of a service uses a technology that is characterised by *economies of scale and scope* (as is the case for electricity distribution – discussed below), an annual tariff regime based on marginal costs is likely to leave the supplier unable to recover all of its costs (and so not meet the *dynamic efficiency* condition). In this situation, the general principles for allocative efficiency are for:

- prices to deliver revenue on a per customer basis that is greater than the *avoidable cost* of continuing to serve that customer and less than the *stand alone cost* of providing the service by the most efficient means; and
- the 'joint and common' costs to be recovered from customers in such a way as to minimise the reduction in demand for the service against the *efficient* level (which is the level of demand that would result were customers to pay only the *marginal cost* of providing the service).

The third condition of efficiency is *dynamic efficiency*. This can be interpreted as least-cost service provision over the long-term. Dynamic efficiency requires that there be incentives for efficient investment so that services valued by the market continue to be provided after the current stock of assets reach the end of their useful lives. This criterion also requires that new investment as well as operating decisions embody the improvements in technology over time.

Relationship between Competition and Efficiency

In the absence of any market distortions, competition would be expected to generate efficient outcomes (that is, to satisfy the three efficiency conditions discussed above). Competition for customers provides the pressure for prices to reflect the cost incurred. If one supplier sought to set price above cost, then a competitor could offer a lower price and still cover its costs, and take away the customer. Similarly, where the existing supplier is not the lowest cost supplier (for example, because it is using an outdated technology), then a lower cost competitor also could undercut it and still cover costs. Lastly, over the long-term, competition should also provide pressure for new technologies and more efficient work practices to be adopted, and therefore for prices to continue to reflect the lowest cost.

Therefore, where all of the decisions relevant to resource allocation (eg: the price charged for a product, how much is bought and from whom) are made by individuals (consumers and firms) and not by a central decision-maker, the presence of competition implies that those individuals will face *incentives* that promote decisions that are consistent with economic efficiency.

In practice, the conditions for *perfect competition* seldom exist. It is generally accepted, however, that, provided there is a *reasonable* level of competition (or

effective competition, as the term is used in the anti-trust literature) in the relevant market, then the outcomes produced by 'leaving it to the market' are likely to be superior to those that could be achieved through regulatory intervention. One particular advantage of a system whereby the relevant decisions are made by individuals (consumers and firms) is that those individuals are likely to have access to far more information than would be available to (or could be obtained by) a single 'decision-maker', such as a regulator.

Where the forces of competition in a market are weak or absent, however, regulatory intervention can be justified in order to encourage economically efficient outcomes and to avoid the resource allocation distortions that can otherwise result from the exercise of monopoly power. Many forms of regulatory intervention are possible. In general, the Office has a strong preference for putting in place mechanisms that provide market participants with the incentive to make decisions that are consistent with achieving economically efficient outcomes and to leave the detailed decision-making to those individuals to the extent possible.[13]

The first issue, therefore, is whether there is likely to be effective competition for the supply of electricity distribution services in the Docklands. This is discussed next.

4.3 Degree of Competition in the Supply of Electricity Distribution Services

4.3.1 Public Submissions

This section summarises a cross-section of the views expressed in the public submissions regarding the degree of competition in the supply of electricity distribution services. A fuller summary of the views expressed in the public submissions received during this process is provided in the Attachment to this Decision.

CitiPower's submissions consistently emphasised the significance of the economies of scale and scope in the distribution of electricity. In addition, CitiPower argued that distributors in the Docklands development, as in other areas, would have market power of a similar kind to the existing distribution networks (arising from these economies of scale and scope). Hence, it considers that the Docklands distribution network should be treated as an exclusive regulated monopoly on the basis that network 'competition', where there are already regulated tariffs, would produce unsatisfactory outcomes. CitiPower stated that it might not have realised all economies of scale and scope across its whole business and that allowing Powercor a licence will lead to an inefficient and unsatisfactory allocation of resources.

Powercor commented that its application was consistent with the Office's objective of promoting competition in network services. It suggested that the granting of an inset licence would enable the Office to lighten regulatory oversight and allow market forces to determine the identity and discipline the behaviour of the network service provider. In the event that Powercor did obtain a licence to distribute in the area, the

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[13] Incentive regulation is an example of such a mechanism. With incentive regulation, firms are able to make higher profits if they exceed benchmark cost or demand levels. The intention of these incentives is to induce regulated entities to select the least-cost approaches for providing electricity distribution services.

threat of 'entry' by CitiPower (and others) would constrain it (Powercor) to charge no more than the stand-alone cost of serving Docklands customers. This would place an appropriate commercial discipline on distribution pricing in the Docklands and as a result, the Office need not regulate the activities of competitive suppliers of distribution services in the area. If, however, it was subsequently found that competition was not effective, then some form of price regulation could be contemplated. In its submission on the *Draft Decision*, Powercor re-emphasised that the risk of by-pass will provide ongoing pressure on its pricing practices. It also noted that if duplicate assets are installed within the Docklands that the barriers to entry associated with the economies of scale and scope are no longer relevant.

AGL Electricity indicated that it: "*is generally supportive of competition in the provision of electricity networks*", but only where there is real benefit to customers and no detriment to existing customers of the competing distribution businesses. As an inset licence should only be allowed on the basis of customer benefit, which should take into account more than just tariffs, AGL considered that there was a need for regulation to protect proposed and future customers in an inset area. In particular, regulation is needed to ensure that customers do not pay more than they would have with the incumbent and that customers in the inset area are not subsidised after taking into account any existing cross-subsidies.

United Energy in its submission stated that it favoured the development of competition in the provision of network services provided this was not distorted by existing tariff regulation. The company's preferred approach is to remove pricing distortions now in place as a result of tariff averaging, adjustments made to asset values and tariffs at the time of privatisation to maintain rural cross-subsidies, and adjustments to transmission charges made to the same effect. This could be achieved by removing restraints on tariff re-balancing and ensuring that new entrants to metropolitan distribution areas incurred similar rural subsidisation costs as incurred by the incumbents.

The Australian Cogeneration Association (ACA) commented that inset appointments should be permitted wherever they are supported by a network customer, irrespective of whether they relate to a greenfield site or to by-pass situations where assets of an incumbent distributor may be stranded. It suggested that this is consistent with the current position where customers have a right to re-configure their supply, select the tariff they are supplied at, and where some customers are exempt from regulatory arrangements. ACA considered that ensuring a right to by-pass would encourage commercial negotiation and result in stronger competition at the margin and pressures for efficiency.

The Institute of Public Affairs (IPA) considered that the opportunity for competition should be maximised and the role of regulation in the industry minimised. IPA considered that by-pass should be automatically allowed and dual supply to an area be permitted. The Powercor proposal was seen as promoting competition. IPA had little concern over the process by which the inset application came about or the impact its approval may have on the incumbent. It also saw no need for detailed consideration of tariffs proposed by the inset applicant or of other aspects such as reliability of its system. It suggested a less interventionist approach to pricing regulation and licensing.

The Docklands Authority indicated that *"the Authority supports market competition for the supply of services, subject to the cost and economies involved e.g. in relation to duplication of services and cross-subsidies"*.

energyAustralia commented that it fails to see the rationale for regulating the price for the use of the trunk once the assets are duplicated, and that if competition concerns remain, it would be appropriate to cap prices at those charged by the local distributor. It also commented that competition between *existing* distribution systems only creates pressure for more costs to be allocated to customers in other areas.

4.3.2 Office's Assessment and Findings

The Office has expressed the view in its various papers and in the *Draft Decision* that the supply of electricity distribution services *after the assets are in place* is generally considered to have strong *natural monopoly* characteristics (ie, a business in which the cheapest form of supply is through one firm)[14] and where many of the costs are *sunk costs* (ie, a new entrant stands to lose a higher proportion of its up-front capital outlay if it is forced to leave the market). It was concluded in the *Draft Decision* that:

- as a result, the distribution licensee that obtains control of the assets in the Docklands would be likely to be the sole supplier of electricity distribution services in the area, and be in a position to exercise market power after it had taken control of the assets; and
- in the absence of any up-front commitment about future price and service levels, regulation (along the lines of the existing regulatory framework) of future prices and service levels in the Docklands would be justified.

In relation to the Docklands, if Powercor were licensed, the developers for the individual precincts would arrange for the provision of electricity distribution services, and so determine who gets to provide (or control) the assets for individual precincts. As a result there would be only one set of distribution assets installed initially within each of the precincts. The implications of this are as follows:

- First, if other distribution licensees can get *regulated* access to Powercor's trunk or any trunk assets controlled by CitiPower (ie the *trunk* assets are regulated, but the within-precinct assets are not), then any new entrant would need to duplicate assets within the precincts in order to supply customers. Accordingly, any new entrant (including Powercor and CitiPower) would face a cost disadvantage in serving a subset of any customers served by the incumbent (as this service is likely to be characterised by economies of scale and scope), which would act as an entry barrier and provide the incumbent with some protection from competition.
- Secondly, if the trunk assets supplying the Docklands were also unregulated, then any other potential entrant apart from Powercor and CitiPower would have to duplicate the trunk as well as intra-precinct assets in order to supply within the Docklands, and so face an even greater cost disadvantage in supplying the precincts. The Office is not satisfied that the existence of two players in a market

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[14] See, for example: Chapter 6, *Markets for Power, An Analysis of Electric Utility Deregulation*, Paul L Joskow and Richard Schmalensee, MIT Press, Cambridge, Massachusetts, 1983.

where there are significant barriers to entry is likely to imply that there is effective competition and no role for regulation.

Accordingly, the Office considers that any 'threat of entry' by other distribution licensees into the Docklands and by-pass by large customers would be unlikely to provide a sufficient discipline on future pricing and service levels in the Docklands to eliminate the need for some form of ongoing regulation. It also follows that the Office does not see the relevance of Powercor's statement that '*if assets are duplicated within the Docklands, then the theoretical economies of scale and scope arguments do not apply*'.[15] Duplication of assets within the precincts will not occur initially, and the control of these assets (as well as having only two potential providers of trunk infrastructure) is expected to give rise to significant protection from competition for the incumbent.

Powercor has also intimated that there would be pressure for it to peg its charges within the Docklands at CitiPower's charge for comparable services in surrounding areas.[16] Powercor has suggested that CitiPower's network tariffs in surrounding areas provide an appropriate benchmark against which to assess the reasonableness of Powercor's Docklands tariffs. The Office remains of the view, however, that CitiPower's existing tariffs are not an appropriate benchmark for the Docklands.

As discussed in the *Discussion Paper* and *Pre-Decision Consultation Paper*, CitiPower's asset value was adjusted at privatisation so as to be above the level of new entrant costs (optimised depreciated replacement cost). The consequence of this privatisation adjustment to CitiPower's asset value is that the cost of providing, maintaining and operating infrastructure for a major greenfields distribution development, such as Docklands, may be substantially lower than that implied by CitiPower's current standard tariffs. It follows that, even if Powercor (or another distribution licensee) funds all of the assets within the Docklands, it would be expected to earn excessive returns were CitiPower's standard tariff to be charged.[17] Moreover, to the extent that Powercor intends to seek up-front contributions from developers (as is standard practice for such developments – discussed in section 6.3 below), then greater monopoly rents would be expected.[18]

Accordingly, the Office considers that in the absence of any up-front commitment about future price and service levels, regulation (along the lines of the existing regulatory framework) of future prices and service levels in the Docklands would be justified. That is, in the absence of regulation, prices would be expected to be

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15 Powercor, *Powercor's Licence Application to include the Docklands Area: Submission to the Office of the Regulator-General, Response to the Draft Decision*, 16 July 1999, page 6.

16 In its licence application, Powercor stated that its network tariffs '*would be less than or equal to the current relevant tariffs of CitiPower*'.

17 Note that when the regulatory asset values of the distribution businesses were determined in 1994, the value of all shared assets were included in the value, regardless of historical customer contributions.

18 Under the proposed regulatory treatment of the Docklands, it would be expected that distribution businesses may charge their standard tariffs.

However, the costs and revenue associated with the Docklands would be 'rolled-in' to the distributor's existing businesses. The effect of this would be that any difference between costs and revenue associated with the Docklands would be passed on to the distributor's existing customers rather than being captured by the distributor.

significantly in excess of the cost of providing a distribution service in the Docklands. Monopoly profits would accrue to the distribution licensee in each precinct and/or to developers who would be in a position to demand up-front inducements from prospective distribution licensees for the right to own and operate the infrastructure.

4.3.3 Some Implications

As noted above, the Office is keen to explore mechanisms under which competition may align the incentives of distribution licensees and developers with efficient outcomes, and thereby reduce the extent to which the Office is required to get involved in detailed decision-making. It was noted in the *Pre-Decision Consultation Paper* that even where ongoing competition for the supply of a service is weak or absent, competition may exist for a limited period of time for some components of that service. Provided the framework is appropriate, a mechanism that harnesses this competition can be a powerful tool for aligning the incentives of participants with efficiency.

In the *Pre-Decision Consultation Paper*, the Office also noted that, in principle, a competitive market exists for the provision of electricity distribution services in an area prior to the assets being installed and control passing to the distribution licensee. The Office discussed an option for harnessing that 'window of competition' for selecting the distribution licensee and setting the price/service levels for electricity distribution *within the Docklands precincts.* The Office's views on the feasibility of the franchise bidding approach are discussed in section 4.4.

As noted earlier, the Docklands Authority has already held a process to select the *provider of the trunk distribution services*, in which the Transfield/Powercor consortium was the successful bidder. Accordingly, Powercor is likely to be a provider of distribution services to the border of some or all of the precincts if the Office grants it a licence to operate this infrastructure. This raises the issue of whether Powercor is likely to be the lowest cost supplier of this service, and if not, whether such a licence should be granted. If such a licence was granted to Powercor, the regulatory regime that should apply to that facility is also a matter for consideration. These issues are discussed in section 5.

4.4 Feasibility of Franchise Bidding for Selecting Electricity Distribution Licensees

4.4.1 Public Submissions

This section summarises a cross-section of the views expressed in the public submissions regarding the feasibility of using a franchise bidding process to select the electricity distribution licensee for a particular area or project. A fuller summary of the views expressed in the public submissions received during this process is provided in the Attachment.

CitiPower questioned whether, if the proposal required an exclusive licence to be granted to the winning party, such a licence would be sustainable at law given that CitiPower already has a licence to distribute in the area. CitiPower also questioned whether, if the model contemplated re-auctioning the "*franchise*" at its expiration, this would provide the incentive for efficient maintenance and renewal of the assets. It

also doubted whether developers would have the incentive to require a commitment over future prices and service levels (this issue is discussed further in section 6) and noted that there would be difficulties in ensuring that any benefits under a contract between a distribution licensee and developer could be transferred to end-users. CitiPower also questioned the practicality of using a franchise bidding process to set prices for the Docklands given its geography and the lack of access to the area for other distribution licensees.

Powercor also questioned the legal basis for undertaking a franchise bidding process and stated that such a process would lead to unacceptable delay. Powercor's view was that developers could be relied upon to obtain appropriate future price/service commitments, and that any enforcement problems over these commitments could be overcome. Regardless, Powercor considered that ongoing competition for Docklands customers would provide appropriate discipline on the pricing for distribution services and so a franchise bidding process would be unnecessary.

United Energy commented that the franchise bidding process, as outlined by the Office, would be unlikely to ensure that end-users obtain the benefits from competition (rather these benefits would flow through to the developers).

AGL offered some support for the use of a franchise bidding process to set future price/service standards, but noted that the administrative costs involved imply that it is only likely to be feasible above a minimum scale. AGL stated that the day-to-day management of the process should be in the hands of the developers, and that the regulator should only enforce the commitment if the developer is unable to monitor and enforce the initial commitment.

Mirvac expressed support for the objective of harnessing competition in the supply of electricity distribution services, but also noted that their projects in the Docklands need the matter of Powercor's licence application considered quickly.

Energy Projects Division stated that the Government intended to encourage contestability in the provision of new distribution infrastructure. It expressed the view that the Office should play a limited role in the ongoing regulation of the price and supply of distribution services where a binding up-front price/service contract is struck between a developer and the distributor of choice (with this role limited to ensuring that minimum standards are met). Where such contracts do not exist, or have expired, existing regulation should apply.

4.4.2 Office Assessment and Findings

Introduction

The Office confirms the view it has expressed previously that, in principle, there is scope for effective competition between potential distributors *prior* to the transfer of the assets to the successful licensee (or prior to the installation of the assets if the successful licensee also undertakes the design and construction). That is, while market power will accrue after the transfer of the assets, there is scope for effective competition for the right to supply electricity distribution services in a particular area *prior* to the transfer or installation of the assets.

The Office has discussed the use of an 'auction' or franchise bidding process to determine the allocation of the right to supply the electricity distribution services in a particular area.[19] Under this model, the 'winner' would be selected on the basis of the price/service commitment it offered to maintain for a specified period after it had taken control of the assets. If implemented successfully, this approach would be expected to produce a competitive 'commitment' and, if this commitment is enforced, an appropriate discipline on ongoing price and service. After the initial commitment had expired, the supply of electricity distribution services would be regulated on the same basis as in other areas. The role of the Office in the conduct of the process, and enforcement of the commitment, is discussed below.

The Office does not agree with CitiPower's criticisms that the process as outlined previously would lead to perverse incentives for maintenance and renewal of the network or require an exclusive franchise within CitiPower's licence area. The model outlined by the Office specifically did not envisage periodic re-tendering of the franchise as assumed by CitiPower. Rather, the intention was that the assets would be regulated in a similar way to other assets after the term of the initial commitment had expired. In addition, it was not proposed that an exclusive franchise would be issued to the winner of the auction. Rather, it was assumed that the winner's (non-exclusive) licence would give it an exclusive right to use the distribution assets given into its control and that control would provide it with adequate certainty over the recovery of its costs (by virtue of the natural monopoly characteristics of the system).

The Office has also noted, however, that for such a franchise bidding process to be used, there would need to be measures or rules in place to ensure that all bidders are able to compete on a competitively neutral basis. This would be necessary to ensure that selection of the lowest price bid (for a given standard of service) would also result in selection of the lowest cost supplier (and thus achieve productive efficiency).

Role of the Office

There has been some debate as to whether the Office should play a role in the conduct of such an auction and in the ongoing enforcement of such a price/service commitment. On one view, an end-user should be given the opportunity (and responsibility) to negotiate the 'deal' with the distribution licensee that best meets its interests in terms of price and service, and then to enforce this arrangement against the relevant distribution licensee through normal commercial law channels. Under this model, the Office would not have a role until the initial price/service commitment expired. An alternative view, however, holds that market or other failings may justify the involvement of the Office in the conduct of the auction and enforcement of the bid. There are a number of possible roles that the Office could play in these processes.

The Office affirms its view that, where such an auction is to be adopted in relation to a distribution system that will supply widely dispersed end-users (as is expected to be the case in the Docklands), then the Office would need to be involved in the conduct of the franchise bidding process and in the enforcement of the winning bid. This view has been reached for the following reasons.

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[19] See the *Pre-Decision Consultation Paper* and *Draft Decision*.

- First, the Office is not convinced that developers (acting as agents for the ultimate end-users) necessarily will have the incentive to minimise the long-term cost of electricity to end-users. The Office has taken account of the extensive comments provided on this issue, and in particular the pervasive view that the development industry adopts a short-term perspective, which discounts heavily longer-term factors like future electricity prices when assessing impacts on property valuations.
- Secondly, there may be difficulties associated with the enforcement of such a commitment over the long-term once the initial contracting parties (the developers) are no longer involved. From a legal point of view, if the end-users are the ultimate beneficiaries under a contract to which they are not a party, they may have difficulty in enforcing the contract against the distribution licensee (under the rules of contract law). Legal problems aside, however, it is unclear that the small, dispersed and probably unsophisticated end-users will be in a position to avail themselves of contract law remedies against the distribution licensee. One of the rationales for regulation is the inefficiency of normal commercial devices where small, widely dispersed participants are involved.
- Thirdly, the effect of a franchise bidding process would be to set the future price/service commitment, and so displace the normal regulatory regime for the supply of distribution services that exists under the *Tariff Order*. As such, the Office considers that it has a legislative duty to ensure that the franchise bidding process proves to be an appropriate replacement for the normal regulatory regime by undertaking appropriate monitoring.

The Office considers that, with respect to the conduct of a franchise bidding process, its role should at least be to:

- approve the criteria to be applied to select the 'winner', and
- confirm that these criteria were applied correctly and consistently.

Accordingly, the day-to-day running of the process would be left to the developers (or whoever intends to call for tenders for supply). With respect to the enforcement of the price/service commitment, one mechanism that would provide the necessary power would be to include a suitable condition in the winner's distribution licence.

Appropriateness of the Process for the Docklands

Since the release of the *Pre-Decision Consultation Paper*, concerns have been expressed in submissions about the appropriateness of the franchise bidding process for the selection (and regulation) of distribution licensees for the Docklands precincts. These concerns included the following.

- Such a process would involve a further substantial delay in coming to a decision on the Powercor licence application, which would undermine the competitive position of Powercor (and any other contenders) relative to the position of CitiPower. It would also involve additional administrative costs and processes.
- There is considerable uncertainty surrounding the future development timeframes and overall demand for distribution services in the Docklands, which would make it difficult to participate in and administer a franchise bidding process. The anticipated benefits may be lost if bidders are forced to submit bids that require

the successful distribution licensee to accept substantial risk, while the regulatory cost savings may be nullified if bids contain complex price review clauses.

- There appears to be some ambiguity regarding whether it is within the Office's powers to administer a franchise bidding process for the Docklands development on the lines it has proposed.

After due consideration, the Office confirms the view expressed in the *Draft Decision* that it would not be appropriate to use a franchise bidding process to select the distribution licensee for the Docklands precincts and to determine the future price/service obligations of the successful bidder. However, this should not be interpreted as a general view on the part of the Office that the franchise bidding option should not be considered, and where appropriate adopted, for other future inset licensing decisions.

4.4.3 Some Implications

In section 4.3 the Office concluded that the level of ongoing competition for the supply of electricity distribution services within the Docklands precincts is likely to be weak or absent. The Office has also concluded that, in light of comments received on the *Pre-Decision Consultation Paper*, it would not be feasible to use a franchise bidding process to determine the future price and service levels in the Docklands. Similarly, the Office does not consider that negotiated arrangements between developers and potential distribution licensees will mitigate the need for regulation in the case of the Docklands precincts.

Accordingly, the issue for the Office with respect to the future supply of electricity distribution services in the Docklands is to ensure, as far as possible, that the process by which distribution licensees are to be selected for the Docklands precincts is consistent with achieving economically efficient outcomes and so with serving the interests of customers generally (ie, with selection of the lowest cost provider and distribution tariffs that reflect those costs).

The Office's conclusion with respect to the feasibility of franchise bidding leaves two remaining options for the selection of the distribution licensee for the Docklands precincts. If no further licences were issued, then CitiPower automatically would be selected as the distribution licensee for all of the Docklands precincts. Alternatively, if Powercor (and potentially any other suitably qualified applicant) were to be issued with a licence, then the developers (effectively) would select the distribution licensee, given that the developers have the right to determine who obtains control of the distribution assets within the relevant precinct.[20]

4.5 Consequences for the Office's Licensing Decision

Sections 5 and 6 respectively examine:

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[20] While the Docklands Authority ran the selection process in relation to the provision of trunk infrastructure, the Office is informed that the developers for each of the precinct are the relevant decision-makers in relation to the infrastructure within each precinct.

- whether Powercor should be given a licence right to provide distribution services by means of the trunk infrastructure that is being constructed; and
- whether Powercor should be given a licence right to provide electricity distribution services in the Docklands precincts by way of any relevant distribution asset over which it is selected to have control (and, if so, whether any rules should be imposed governing any such selection process).

If the answer to one or both of these questions is 'yes', then the issue arises as to the specific form of licence that would be the most appropriate. In addition, a number of issues must be addressed regarding how the Office would give effect to the intentions described in sections 5 and 6. The formal requirements of the Office's licensing decision are addressed in section 7.

5. REGULATION AND LICENSING OF THE TRUNK INFRASTRUCTURE

As discussed earlier, Powercor (through its participation in the Transfield consortium) has already been *selected* by the Docklands Authority to provide the trunk infrastructure, and construction of the relevant assets has commenced.

If the Office issues Powercor with a licence to provide electricity distribution services in the Docklands, then Powercor naturally would use this trunk infrastructure to the extent that it becomes the provider of distribution services for any of the precincts. In addition, under its existing licence conditions (as discussed in section 3), Powercor would be required to provide access to the trunk by any other distribution licensee that supplied electricity distribution services to a Docklands precinct.[21]

If Powercor fails to obtain a licence to distribute in the Docklands, then the property right in the trunk infrastructure will pass to the Docklands Authority who would (presumably) offer it to a licensed distribution business (which would be CitiPower if no other licences were issued for the Docklands). CitiPower, however, has stated that the ducts being constructed by the Transfield/Powercor consortium are incompatible with its standard installation arrangements. It is not clear whether this implies that if CitiPower were to be offered the ducts, the least-cost option would be to use those ducts (albeit possibly using a higher cost cable type) or to build duplicates. It is clear, however, that if CitiPower remains the sole licensee in the Docklands, it would have to build additional ducts given it would serve the area through multiple feeders.

Whether or not Powercor receives a licence, CitiPower has the capacity under its present licence to extend its own system into the Docklands to provide services equivalent to those that would be provided by the Powercor trunk assets. That is, there is scope for duplication of trunk infrastructure if both are licensed to distribute in the Docklands.

CitiPower has raised a number of concerns with the trunk infrastructure system proposed (and being constructed) by Powercor to bring electricity to the precinct boundaries. These concerns include the following claims:

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[21] If a new licence rather than a licence variation were to be granted to Powercor, then these access provisions would be included in that licence.

- the net present cost of the system proposed by Powercor is significantly greater than CitiPower's proposed system as CitiPower could make use of economies of scope associated with its existing system;
- regardless, CitiPower will duplicate part or all of the system that will be provided by Powercor, and so Powercor's costs represent *additional* costs that will be borne by end-users, rather than *alternative* costs;
- the Powercor system would lead to lower reliability of supply than CitiPower's given that CitiPower would adopt a meshed 11 kV network supplied by multiple zone sub-stations (three originally, and possibly eventually a fourth within the Docklands) and transmission terminal stations (initially two) rather than through a stand-alone 22 kV loop that is supplied through a single transmission terminal station; and
- Powercor's system would result in a substandard quality of supply compared to the CitiPower option.

The Office engaged an engineering consultant, Connell Wagner,[22] to provide advice to the Office on these matters. The findings of Connell Wagner, and the Office's conclusions on these issues, are discussed in section 5.2.

First, however, it is appropriate to examine the tender process that was conducted by the Docklands Authority for the provision of trunk infrastructure. This will assist in determining the extent to which it is appropriate to draw inferences from the fact that Powercor's bid to provide the trunk infrastructure was part of the winning consortium.

5.1 The Docklands Authority's Tendering Process

The key features of the tendering process were as follows.

- The Docklands Authority conducted the tendering process. The Authority is a statutory body established under the *Docklands Authority Act 1991*. While its general objectives are to develop (and oversight the development of) the Docklands area,[23] it also has as a specific function to *'take, support or promote measures to encourage people to live and work in the area'*.[24] In addition, it has some of the powers and functions of a municipal council; for example, it has the authority to pass local laws, levy rates and charges,[25] and conduct polls on any proposition related to its municipal functions.[26]
- The tender was for the provision of a range of utility trunk infrastructure, of which electricity distribution was a relatively small component.
- The Transfield/Powercor consortium won the right to provide the trunk infrastructure. The Docklands Authority will pay the Transfield/Powercor consortium $71 million for the provision of trunk infrastructure, and recover this

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22 Connell Wagner, *Review of Electricity Supply to the Docklands Site for the Office of the Regulator General*, February 1999.

23 *Docklands Authority Act 1991*, section 9.

24 Ibid, section 10(f).

25 Ibid, sections 35C, 35D and 35E.

26 Ibid, Division 3.

from the developers (who, in turn, would be expected to recover this cost through the sale price of the developed properties).

- A number of criteria were applied in the assessment of the tenders, including the ability to meet desired performance levels and overall cost to the Authority. Powercor has claimed that the cost of electricity infrastructure was not included in the tender price as Powercor expected to recover this cost by charging end-users directly. Also there was no independent assessment of the cost of Powercor's electricity trunk infrastructure proposal relative to the others (such as CitiPower's).
- Prior to the conduct of the tender process, Powercor offered to provide electricity in the Docklands with '*initially lower network tariffs and a better long term price path for consumers*' than would be the case under CitiPower's standard network tariff.[27] Subsequently, Powercor revised its commitment as being that the network tariffs '*would be less than or equal to the current relevant tariffs for CitiPower*.'

A number of possible interpretations may be placed on the tendering process that was undertaken by the Authority.

One interpretation is that the objectives, functions, powers and responsibilities of the Authority imply that it is the most appropriate party to have assessed and determined who should provide the trunk electricity distribution services for the Docklands area and that it would neither be appropriate nor necessary for the Office to inquire further into this decision. There are a number of attractions to this proposition, including that it would be consistent with the Office's preference (discussed in section 4.2 above) for those in possession of the relevant information and responsibilities to have the primary responsibility for making decisions.

However, the absence of sufficient clarity regarding the future regulatory framework for the supply of electricity distribution services in the Docklands may have influenced the Authority to make its selection on criteria which did not have regard to the impact of the decision on the prices and service quality available to future customers of distribution services, both within and outside of the Docklands. If future prices were taken as one of the selection criteria, then comparing a location-specific price that may be proposed by a prospective new entrant distribution licensee with a rolled-in price that may be proposed by (or attributed to) the incumbent may not have resulted in the most efficient provider being selected. Similarly, comparing the final tariff proposals without having regard to the proposed capital contributions to be sought from developers (or vice versa) may also have lead to a misleading impression of the relative costs of the competing proposals.

For these reasons, the Office considers it appropriate to examine further the basis and implications of the Docklands tender process and outcome. The following aspects of the tender process would appear to be most relevant in this regard:

- The tender was for a variety of different forms of infrastructure; the Transfield/Powercor consortium did not include the cost of the electricity assets in the bid price and there was no independent analysis of the cost of Powercor's electricity trunk infrastructure bid against that of CitiPower's. Accordingly, it

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[27] Powercor, *Application*, 4 March 1998.

would be difficult to make an inference that the tender process would be expected to select the least-cost provider of electricity trunk infrastructure for the Docklands.

- Powercor's commitment to provide distribution services in the Docklands at prices that are below (its initial commitment) or at or below (its revised commitment) the equivalent price of CitiPower provides no basis for concluding that Powercor's trunk infrastructure *costs* are likely to be below those of CitiPower. As discussed above, where there is a policy determined wedge between the prices and costs of the incumbent distributor (as is the case for CitiPower resulting from the write-up of the asset value above the estimated new entrant cost level, as discussed in section 4.3.2), a comparison of the potential entrant prices with those of the incumbent may lead to misleading inferences about their relative costs.

While the Office recognises the desirability of leaving participants who possess the necessary information and relevant commercial incentives to negotiate the detailed contractual arrangements where possible, it also recognises that the absence of a well-defined regulatory framework for the Docklands may have caused the Docklands Authority to focus on its own cost commitments rather than the price/service consequences for final customers both within and outside of the Docklands when framing its tender process and deciding the outcome. Accordingly, the Office believes it should examine further the relative merits of the alternative trunk infrastructure proposals of Powercor and CitiPower.

5.2 Assessment of Powercor's and CitiPower's Trunk Infrastructure Options

5.2.1 Relative Cost of the Trunk Supply by Powercor and CitiPower

The Office received material from both CitiPower and Powercor which provided estimates of the cost that would be incurred by the distribution businesses (and which would be passed on to end-users) from providing the trunk distribution assets. The productively efficient (least-cost) option is the one that would involve the lowest incremental cost (in discounted terms).[28] For Powercor, the incremental capital cost would comprise the trunk system and associated connection assets to the transmission system. In contrast, as the CitiPower system would be interconnected with its surrounding system, the incremental cost of its option would comprise the costs that would be incurred as a result of supplying the Docklands in addition to the costs that would be incurred in supplying the surrounding areas.[29]

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[28] The discussion in this section focuses on the productive or technical efficiency of the provision of trunk infrastructure for the Docklands. However, as discussed in section 4.2, the appropriate regulatory criterion is to maximise overall economic efficiency – which also includes allocative and dynamic efficiency, as well as the level of productive efficiency in related markets. The implications for these other components of economic efficiency are discussed in section 5.2.3.

[29] CitiPower provided estimates of the total cost of supplying the Docklands and surrounds under the assumption that CitiPower supplies all of the Docklands and surrounds and has compared this to the total cost of supplying the Docklands under the assumption that CitiPower supplies the surrounds and Powercor supplies the Docklands. This is an equivalent way of expressing the efficiency test. The Office has calculated CitiPower's estimates of its incremental cost of supplying the Docklands from the data that it provided.

Unfortunately, however, much of the data that was provided by both Powercor and CitiPower has been made available on a confidential basis, and so the Office has not been able to subject this information to public scrutiny. The weight that can be placed upon the information provided by both CitiPower and Powercor is, therefore, reduced substantially. Nevertheless, the Office has considered it necessary for the discharge of its statutory responsibilities to form a view about the relative costs of the CitiPower and Powercor trunk supply options, and to take account of any cost differential when deciding whether Powercor should be provided with a licence to distribute electricity in the Docklands. Accordingly, the Office has analysed the information provided by both CitiPower and Powercor, and engaged Connell Wagner to assist in this analysis.

Connell Wagner drew two conclusions regarding the relative cost of the Powercor and CitiPower trunk infrastructure options, which were:

- *'the CitiPower option is most likely to be the more economic in terms of NPV than the Powercor solution'; and*
- *'the CitiPower option offers more flexibility to cater for a wider range of incremental load growths and load sizes than does the Powercor option'*.[30]

The main reason that Connell Wagner advanced for CitiPower's cost advantage was that it '*should enable the maximum amount of deferment of capital works (and hence expenditure) as it levers off the existing network'*.[31] The Office interprets this as implying that CitiPower would be in a position to realise economies of scope associated with extending its system to supply the Docklands precincts.

There were a number of assumptions adopted in the cost estimates by both Powercor and CitiPower that Connell Wagner advised were significantly different to the assumptions that it would consider prudent. For example, Connell Wagner considered that:

- Powercor's estimates of the maximum Docklands demand may be excessive by up to 50 percent, whereas CitiPower's estimates were considered to be too low.[32]
- CitiPower's estimates of the costs of a number of the elements in its option were considered too low, including the cost of the civil works involved in installing ducts in the Docklands area, the land cost for the proposed future zone substation in the Docklands, and the possible requirement for cable river crossings rather than using the Charles Grimes Bridge.[33]
- Powercor's estimates of a number of the costs associated with its option were too low, including the cost of a zone substation at the Fisherman's Bend Terminal Station and the additional cost of interconnecting the precinct distribution networks should CitiPower become the provider of distribution services for some of the precincts.[34]

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30 Connell Wagner, op cit, page 19.

31 Ibid, page 9.

32 Ibid, pages 5 and 6.

33 Ibid, page 9.

34 Ibid, page 10.

Connell Wagner commented, however, that when adjustments are made for these items in its assessment of the relative net present cost of the two options, there would still be some difference in the prospective net present costs of the options in favour of CitiPower's proposal.[35]

On the basis of Connell Wagner's advice, the Office accepts that there is evidence that the CitiPower trunk infrastructure option appears to involve the potential to achieve a lower net present cost than the Powercor option, and the Office has formed a view about the likely magnitude of the potential cost disadvantage of the Powercor option. This information has also permitted the Office to form a view about the absolute costs of the CitiPower and Powercor trunk systems. The Office also accepts there is evidence that the CitiPower option would have some advantages over the Powercor option in terms of flexibility in catering for changes in the projected load over time in the Docklands.

Against this, however, the Office notes that, if CitiPower remains in a monopoly position, there may be reason to question whether it would have the incentives to realise fully those economies in practice. That is, while the incentive-based regulatory regime that is administered by the Office should provide the regulated distribution licensees with the incentives to invest in and operate the system efficiently, any regulatory regime is second-best to the incentives provided by effective competition.

Moreover, the Office acknowledges there is the possibility that CitiPower will duplicate part or all of the service potential provided by the Powercor trunk if CitiPower supplies some of the precincts and decides to install its own feeders. If CitiPower can convince the Office that this duplication represents efficient investment,[36] then the effect would be that customers as a whole would pay for assets that are not technically required. Accordingly, the combined cost of Powercor's and CitiPower's assets which the Office accepts as efficient investment may exceed the cost that would have been incurred by CitiPower as sole supplier. The actual extent of any such duplication will depend upon which precincts Powercor and CitiPower win the right to supply.

The Office considers, however, that licensing Powercor to provide the trunk infrastructure may give rise to efficiency gains in the provision of electricity distribution infrastructure within the Docklands precincts, and may also lead to efficiency gains in related markets. In considering whether providing Powercor with a licence to operate the trunk infrastructure maximises overall economic efficiency, these other effects need to be taken into account. These other components of economic efficiency are discussed in section 5.2.3.

5.2.2 Security, Reliability and Quality of Supply

Under the regulatory regime that applies to the electricity distribution services within Victoria, the Office does not undertake an assessment of the design of the electricity

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35 Ibid, page 9.

36 In assessing whether such duplication were efficient, the Office would place weight upon the argument presented in this *Final Decision* that the duplication might have led to an increase in the level of competition for the provision of intra-precinct assets, thus providing the offsetting benefits that are discussed in sections 5.2.3 and 6.3.

distribution systems before they are installed. Rather, the distribution businesses are responsible for planning and designing their electricity distribution systems such that they provide an appropriate standard of service (of which security, reliability and quality of supply are different aspects). The Office monitors the performance of the distribution licensees against specified standards and has powers to undertake remedial action where these standards are not being met. For example, if poor service is the result of a poorly designed system, then the Office could require the problems to be remedied at the distribution licensee's expense – that is, customers can be protected from any inefficiency on the part of the distribution licensee. This regulatory approach is limited to ensuring that the entity with the expertise in the design of electricity systems – the distribution business – bears the responsibility associated with system design.

Accordingly, CitiPower's request for the Office to undertake an examination of the technical suitability of the Powercor system prior to it being installed is asking the Office to perform a role that the Office does not undertake, and does not plan to undertake, in relation to the remainder of the Victorian distribution system. Indeed, if CitiPower had just extended its existing system into the Docklands like any other network extension, then the Office would not have contemplated undertaking any assessment of the technical suitability of the network design that CitiPower proposed. As a general principle, *ad hoc* intervention by the Office on network design is undesirable as it weakens the line of responsibility intended for decisions on network design matters that was described above.

The proposed design of Powercor's system was nevertheless raised with some prominence by CitiPower in its submissions. In order to take proper account of CitiPower's representation, the Office considered it necessary to undertake some investigation of the technical merits of the Powercor proposal. In addition, so that the Powercor option can be compared with the default option (CitiPower), the Office also undertook some investigation of the technical merits of the CitiPower proposal. As summarised in the *Draft Decision*, the Office engaged Connell Wagner to assist in this assessment. Subsequent to the *Draft Decision*, the Office has obtained further (verbal) advice from Connell Wagner, and has commissioned a further study from them (discussed further below).

A summary of the views expressed by Connell Wagner to the Office on the performance of the proposed Powercor system is as follows:

- Connell Wagner noted that any measure of reliability needs to take account of the network right up to the customer's connection point, and that often the radial network supplying customers contributes significantly more to unreliability than the upstream network. Accordingly, Connell Wagner concluded that '*it is unlikely that the comparative reliability of the Powercor and CitiPower trunk infrastructure will be the dominant factor in the ultimate reliability of the final customer's supply'*, which is likely to be most influenced by the features of the intra-precinct distribution networks.[37]
- Connell Wagner has, however, advised that Powercor's proposal to take supply from only one terminal station (compared to two under CitiPower's design) and

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[37] Connell Wagner, op cit, page 12.

one zone sub-station (compared to three and ultimately four under CitiPower's proposed design) suggested that the Powercor system could be more subject to very low probability but high impact events.

In its *Draft Decision* the Office formed the view that, while Connell Wagner (and others) made observations about the relative merits of the design of the Powercor system, these matters did not provide a sufficient basis for denying Powercor a licence. This view was influenced by the role of the existing performance monitoring regime, under which Powercor will bear the responsibility for the ultimate performance of its system. Under those arrangements it is within the Office's powers to shield customers from bearing additional costs should concerns about the design be substantiated by its subsequent performance.

Since the publication of the *Draft Decision*, CitiPower has again raised concerns over the technical suitability of Powercor's proposed design, and has directed the Office to the comments that were made by Connell Wagner in its original report. CitiPower also commented that safety concerns might arise if there is more than one distribution licensee with cables in the same geographic area. Connell Wagner addressed safety issues in its original report, however, and concluded that "*it is possible to implement systems to address [safety] concerns*",[38] although Connell Wagner also noted that such systems would not otherwise be necessary.

The Office still considers that it would be inappropriate to deny Powercor a licence out of concerns about the technical suitability of the proposed design. Rather, the Office considers the more appropriate course of action would be to rely upon the existing regulatory framework for ensuring that any distribution system that is installed by Powercor provides an appropriate level of service. It follows that the act of providing Powercor with a licence to provide electricity distribution services within the Docklands should not be interpreted by Powercor or any other party as providing any warranty as to the technical merits of Powercor's proposal.

Equally, however, caveats that the Office has noted regarding the Powercor design should not be interpreted as implying that Powercor will not provide an appropriate standard of service.

5.2.3 Offsetting Benefits from Licensing Powercor

The Office considers that there are potential efficiency benefits associated with providing Powercor with a licence to operate the trunk infrastructure that need to be taken into account when considering whether such a licence is in the long term interests of end-users.

Permitting Powercor to use its own trunk to bid to supply the Docklands precincts is likely to enhance Powercor's competitive position for the supply of intra-precinct assets.[39] While CitiPower's existing licence conditions would require it to provide other distribution businesses, such as Powercor, with access to its infrastructure in order to compete to provide the intra-precinct assets, there are well-established

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38 Connell Wagner, op cit, page 15.

39 The Office's proposals for facilitating competition in the provision of intra-precinct assets, and the projected benefits from this competition, are discussed in section 6 below.

problems with the enforcement of such rights of access.[40] Accordingly, the Office considers that Powercor is more likely to compete for the provision of intra-precinct distribution assets, and to compete more effectively, if it has its own trunk infrastructure into the Docklands. In addition, other distribution businesses that might like to compete with both CitiPower and Powercor are likely to negotiate better terms of access for the use of trunk infrastructure if there are two potential providers of this infrastructure. That is, the problems with the enforcement of such rights of access are less significant (and so the degree of competition for the right to supply the precincts would be greater) if there are multiple providers of the relevant trunk infrastructure. Accordingly, the existence of Powercor's trunk infrastructure is likely also to enhance the competition provided by other distribution businesses for the right to provide the intra-precinct assets.

On the criteria established in section 4, licensing Powercor to operate its trunk will be in the interests of customers if the benefits from this competition are expected to outweigh any potential additional costs (as discussed in section 5.2.1 above) from providing such a licence. The benefits that might flow from competition for the right to supply the intra-precinct assets include:

- a reduction in the cost of the assets within the precincts as the design of the networks is exposed to competitive pressure;
- cost reductions that might flow from the introduction of new ideas or techniques into the design of the systems; and
- reductions in the development costs arising from the pressure for the electricity distribution business to be more responsive to the needs of developers.[41]

It is a difficult task to quantify, to any degree of accuracy, the enhancement to competition that might flow from licensing Powercor to operate the trunk infrastructure, or to quantify the efficiency and end-user benefits that might flow from such an enhancement to competition. There is a widespread view, however, that competition, where it exists, is far superior to regulation for encouraging efficient outcomes. The competition policy reforms implemented by all Australian governments in 1995, and much of the reform of the energy sector in Australia, is based on this philosophy. This view was also expressed in a number of the public submissions that the Office received on this matter.

Accordingly, the Office considers that it is justified in assuming, in the absence of any compelling evidence to the contrary, that the benefits expected from competition are

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[40] Many of the problems with enforcing such access regimes arise from the fact that Powercor would be wanting access to CitiPower's assets in order to compete with CitiPower in the downstream market, and so CitiPower may have incentives to impose barriers to Powercor's access to that market. For the gas industry, the *National Code for Access to Natural Gas Transportation Systems* (which imposes an access regime for gas transportation infrastructure) includes elaborate ring-fencing regulation in an attempt to overcome such incentive problems.

[41] There are a number of ways in which the actions of the distribution business could affect the developer's development costs. For example, if an incumbent electricity distribution business has a protected right to design (or approve the design) of the electricity assets, then it might be insensitive to delays that its decision-making might cause for the overall project. Such a time delay would raise the financing costs of the developer, and so increase its development costs.

likely to be significant rather than trivial. In addition, for most of the precincts, the Office understands that the total cost of the intra-precinct infrastructure (which might be *less costly* if Powercor is licensed) is likely to exceed substantially the cost of the trunk infrastructure (which might be *more costly* if Powercor is licensed). Accordingly, the benefits that might flow from having a more responsive electricity distribution business (as a result of competition) could be substantial.[42]

In light of the possible magnitude of the potential enhancements to economic efficiency from competition for the right to provide the intra-precinct assets as discussed in this section, and having regard to the relative small size of the potential additional costs from licensing Powercor to operate trunk infrastructure (discussed in section 5.2.1), the Office has concluded that, on balance, the potential benefits to customers that are likely to flow from licensing Powercor are likely to exceed the costs.

In section 6 the Office examines options for providing a choice of distribution business for the provision of distribution services within the Docklands precincts. The availability of an alternative means of supply to the borders of the precincts should enhance the level of competition in that related market and so produce more efficient outcomes. Thus, the availability of alternative trunk infrastructure service providers is likely to result in dynamic efficiency gains in related markets which may offset some or all of the costs arising from less than efficient trunk supply arrangements.

5.3 Conclusions on Licensing Trunk Infrastructure

The analysis undertaken by Connell Wagner provides some evidence that the Docklands Authority tender process may not have selected the least-cost provider of electricity trunk infrastructure services for the Docklands. The Office also accepts that providing Powercor with a licence to operate the trunk infrastructure might lead to the duplication of some trunk assets which, if accepted as efficient by the Office, would increase the cost borne by customers.

Offsetting this, however, the Office considers that providing such a licence would enhance the level of competition for the right to provide the distribution assets within the Docklands precincts (discussed in section 6). The Office considers that this competition would provide pressure for a reduction in the cost of installing the assets within the precincts, and could also lead to a reduction in the costs of the overall development (due to pressure on the distribution business to be more responsive to developer needs).

The Office has concluded that the benefits to customers from permitting this competition are likely to outweigh the costs.

The Office has undertaken some analysis of the technical suitability of the Powercor option. As noted above, such an assessment is unusual, as the Office does not normally assess the technical suitability of network extensions before they occur. While Connell Wagner (and the Office) have noted some relative disadvantages of the

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[42] In the case of the Docklands, the increased financing cost arising from only a small deferral in the project (discussed above) could swamp any potential cost differential between the CitiPower and Powercor options.

Powercor design, the Office considers those concerns provide an insufficient basis for deciding against providing Powercor with a licence.

Under the current electricity regulatory regime, Powercor as the relevant planning authority is responsible for designing and installing a trunk infrastructure system which provides efficient and reliable distribution services to the Docklands precincts it serves. The Office's role is to monitor and report on the performance of the distribution networks and to take remedial action when the performance provided does not meet the licence requirements. The Office also considers the efficiency of any investments made in the network at each five yearly price review in deciding whether such investments should be included in the regulatory asset base. The Office, therefore, expects that Powercor will address any remaining concerns about its trunk infrastructure design during its construction and ongoing operation and the Office will be in a position to keep those matters under review through its ongoing performance monitoring regime.

The Office has therefore concluded, on the basis of its consultant's advice and its assessment of the issues, that Powercor should be provided with a licence to operate the trunk electricity infrastructure it is currently constructing in the Docklands.

5.4 Proposed Regulatory Framework for the Trunk Infrastructure

Consistent with the discussion in section 4.3 above, the Office sees no reason to exempt the trunk infrastructure from the regulatory arrangements that apply to the distribution infrastructure in Victoria. Amongst other things, the regulatory regime would need to:

- require Powercor to provide access to *retailers* who wish to retail electricity in the Docklands, and to other distribution licensees who may wish to connect to the trunk in order to compete in the provision of electricity distribution services within the precincts; and
- enable the Office to determine the charges for the use of the trunk.

In the *Draft Decision*, the Office expressed a preference for regulating the trunk assets as a stand-alone piece of infrastructure. However, in response to the *Draft Decision*, concerns were raised in submissions that regulating the Docklands assets separately from the rest of the system will raise the cost of regulation. Submissions also noted that there is substantial uncertainty over the future load (and timing of that load) in the Docklands, so that regulating the area separately raises the possibility of significant future price shocks for the area and the prospect of significant stranded asset risk.[43] The Office has given weight to these concerns in framing this *Final Decision*.

Accordingly, the Office has decided that the use of the trunk assets should be regulated under the price controls that apply (and will apply) to Powercor's current regulated business. This would permit Powercor to charge its relevant standard tariff

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[43] CitiPower also noted that, by aggregating its existing business with the Docklands, the demand-related risk to its revenue might be reduced. This result would follow where some of the demand that is forecast for the Docklands is relocation of demand from the Melbourne CBD or any other area that is served by CitiPower to the Docklands.

for any customer that takes supply directly from the trunk, or to set a new tariff specific to the Docklands trunk infrastructure (within the constraints of the current price control arrangements).

The Office is in the process of reviewing the price controls that apply to Powercor, CitiPower, and the other electricity distribution licensees, and new price controls will be determined for the period 1 January 2001 until 31 December 2005. Under the approach described above, the assets in the Docklands that Powercor would be expected to fund (and which the Office considers would represent efficient investment), and the forecast of Powercor's market in the Docklands, would be included in the calculation of the new price controls for Powercor's regulated business.

Powercor has raised a concern that there will be insufficient information about the likely costs and demand associated with the Docklands development for these to be included in the Office's current review process for the distribution price controls. That process will involve the five electricity distribution businesses making, by 1 December 1999, a consolidated price and service offering covering the period from 1 January 2001 to 31 December 2005. Powercor has stated that there would be sufficient information available in relation to the Docklands by February 2000.

The Office accepts that there is uncertainty at present about the future costs and demand in the Docklands and that some of this uncertainty may be removed in the near future. The Office notes, however, that uncertainty about future cost, demand and revenue is a generic feature of five-yearly price review processes. The Office is also mindful that the commitments it has made to ensure full and effective consultation with customers will not be advanced if there are significant omissions from the distribution business' price and service offerings that are to be presented by 1 December 1999. Accordingly, the Office considers the preferred approach to be for CitiPower, Powercor and any other distribution licensee who expects to provide distribution assets within the Docklands to include their current forecasts of costs and revenues associated with the Docklands in their price/service offerings, and for those forecasts to be revised during the review process as more information becomes available. It is noted that the Office's *Draft Decision* on the new price controls is scheduled to be released in May 2000, and a *Final Decision* in September, and that other cost and revenue assumptions will be revised between the presentation of the price/service offerings and the *Final Decision*.

Any other potential supplier of distribution services within the Docklands precincts (other than CitiPower and Powercor) is likely to be concerned about the pricing of *connection* by other distribution businesses to the trunk infrastructure. Pursuant to clause 5.7 of the *Tariff Order*, prior to 31 December 2000, the Office may regulate charges for excluded services including *'connection to the Distributor's Distribution System'* (clause 5.7.3(b)). Clause 5.7.5 provides that:

> *'Terms and charges for excluded services will be set in accordance with the provisions of the Distributors' distribution licences issued under part 12 of the EIA and subject to oversight under the ORG Act.'*

Accordingly, while connection charges will be determined by commercial negotiations in the first instance, should a dispute arise the Office may make a

decision on the terms and conditions of any connection to the Docklands distribution system. The Office will be guided by clause 4 of the distribution licence and in accordance with *'fair and reasonable'* principles.

6. SELECTION OF THE DISTRIBUTION LICENSEES FOR THE PRECINCTS

Section 5 examined the licensing and regulatory issues associated with the Docklands trunk infrastructure. This section examines issues involved in the selection, licensing and regulation of distribution businesses wishing to provide electricity distribution services *within the Dockland precincts* once the relevant distribution assets have been installed.[44]

Section 4.4 noted that there are two options for the selection of the distribution licensee for the Docklands precincts. If no further licences are issued, the licensee will be CitiPower as it would be unlawful for any other distribution business to provide electricity distribution services in the area (this is referred to below as the 'CitiPower option'). In contrast, if Powercor (and potentially any other suitably qualified applicant) were issued with a distribution licence, then the developers (effectively) would select the distribution licensee for the Docklands precincts (this is referred to as the 'developer selection option' below).[45]

The main objective for the process or rule that is used to select the preferred distribution licensee for the Docklands precincts is to ensure economic efficiency (and, therefore, customer benefit) is maximised. While a key requirement is for the least-cost provider of the service to be selected, the effect on the other components of economic efficiency (such as the technical efficiency in related markets and the implications for the introduction and diffusion of new ideas within the industry) also need to be taken into account. Once the assets are in place, however, it has been concluded that there will be much less ongoing pressure for maintaining efficiency, and there will be the scope and incentive to exercise market power. In that situation, the provision of appropriate incentives for efficient service delivery will be pursued through the design of an appropriate regulatory regime.[46]

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44 The Office is informed that the only precinct where distribution assets have been installed is the Colonial Stadium. CitiPower will be supplying the Stadium through an extension of its existing system, and the Docklands Authority has released Powercor from the obligation to provision trunk infrastructure to the Stadium site.

45 This follows because the developers for the precincts would have the ability to select to which distribution licensee they give control of the distribution assets. As noted in the previous section, however, regardless of who is selected as the distribution licensee for the Docklands precincts, the Office will determine regulated prices and service standards for the provision of electricity distribution services therein.

46 Where prices are regulated, care needs to be taken regarding the inferences that may be drawn from comparing prices. While, under competition, prices should reflect cost, this need not necessarily be the case where regulated prices are determined. For example, as part of the reforms to the Victorian electricity supply industry, a number of measures were put in place to meet Government policy objectives that would be expected to result in a wedge between price and cost (these policy measures were discussed in detail in the *Discussion Paper*). Where there is a wedge between price and cost,

As noted earlier, electricity distribution systems are characterised by significant economies of scale and scope. The existence of economies of scope (as discussed in section 4.3 above) implies that cost savings may result from designing a distribution network to take account of the supply to *the whole of an area*, rather than on a piecemeal or incremental basis. However, economies of scope are only likely to be significant across a continuous integrated network and, for example, will not extend past a physical break in the network. The area over which economies of scope are available will depend upon a number of factors, including the topography, density of demand and projected growth of demand.[47]

The process or rule for selecting the distribution licensee for each Docklands precinct should also seek to minimise the Office's role in the assessment of the cost-effectiveness of the various supply options. The relevant participants are likely to have far more information than the Office regarding the relative costs of the various options. Superior outcomes are therefore more likely if those participants are responsible for making the decisions and they have incentives which are aligned with the achievement of economically efficient outcomes.

It is noted that the objective of providing a competitive discipline on the design of the system might (at times) conflict with the objective of optimising the design of the system to incorporate all of available economies of scope. If such a conflict occurs then an assessment is required as to which effect is dominant and, therefore, which decision will lead to the lowest cost to customers.

The two options identified above for selecting the distribution licensee for the Docklands precincts are examined below against the background of these general comments and principles.

6.1 Assessment of the CitiPower Option

The 'CitiPower option' would put in place the same process for the design, construction and operation of the distribution network as exists currently for typical new area developments. CitiPower would be responsible for the design of the system for the whole of the Docklands.

The fact that CitiPower would be the *de facto* planning authority for the whole of the Docklands area suggests that it should be able to develop a network design which realises any available economies of scope in the provision of distribution services

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comparisons of the price offerings from different distribution licensees may not provide an accurate comparison of their relative costs.

[47] The economies of scope discussed above relate to the cost advantage that a single distribution business may have over a certain area in relation to the distribution assets. This advantage occurs because some of the costs for a particular area are fixed, and so if one distribution business serves that area, the fixed costs are shared by a larger number of end-users, and unit costs are minimised. That said, however, it is an empirical question as to the size of the distribution area that is required to exhaust these economies of scope. There may also be economies of scope available from being able to share operating expenses, such as billing and overheads (as a portion of the costs of these activities are fixed, and so the unit cost falls as the number end-users rises). However, these economies of scope are likely to be available for any other utility operation – such as other electricity distribution businesses, as well as potentially gas distribution businesses.

within the Docklands area. As its existing network surrounds the Docklands and can be interconnected with the Docklands precincts from a number of existing terminal and zone sub-stations, it should also be in a position to realise those economies.

However, in the absence of potential competition from an alternative distributor in the Docklands, and given the existing regulatory framework applying to incumbent monopoly distribution licensees, there is a remaining question as to whether CitiPower would have a strong incentive to design and implement an optimal network for the Docklands in practice. On the one hand, a reduction in capital expenditure would increase CitiPower's profits within the current regulatory period, with some or all of these benefits being retained in the subsequent regulatory period.[48] On the other hand, CitiPower may have an incentive to inflate its capital expenditure and so its regulatory asset base by means of a less efficient investment option, particularly if the rate of return used to determine the benchmark revenue requirement is expected to be above the market cost of capital associated with the relevant activities. Thus, while the incentive-based regulatory regime that is administered by the Office should provide the regulated distribution licensees with some incentive to be efficient, perverse incentives may also exist. Accordingly, where there is no effective competitive threat, an incumbent monopoly distributor may have incentives that are inconsistent with optimising the design of the network augmentation.

As the construction of the assets would be treated as customer-initiated augmentation, CitiPower would be bound by its electricity distribution licence to seek competitive tenders for the construction of the assets.[49] Accordingly, the costs of constructing the network as designed would be exposed to the discipline of competition.

6.2 Assessment of the Developer Selection Option

6.2.1 Incentives of the Developers

In the absence of further specification by the Office regarding the way prices will be regulated in the future, it is not clear that the developers necessarily will have the incentive to select the lowest cost supplier of electricity distribution services within the Docklands area.

If the successful distribution licensee considers that it will have the discretion to later recover through regulated charges any costs incurred, then contenders for the Docklands business (and for a licence) may have the incentive to reduce the capital contribution sought from developers, or even to offer up-front inducements to the developers in order to improve their chances of selection. While developers should, in principle, be concerned that higher ongoing electricity charges would reduce the market values of the developed properties, a number of submitters expressed the view that the features of the development industry cause developers to adopt a very short-term perspective in relation to property valuation and discount heavily these longer-term factors.

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48 The extent to which benefits from under-spending on capital are retained into future regulatory periods will depend upon the position the Office takes on such benefit sharing in the context of its periodic electricity distribution price control decisions.

49 Clause 9.

In addition, if the Docklands is expected to be treated as an extension of the distribution businesses' existing systems (that is, the cost and revenues from the new area are expected to be rolled-in to the existing tariffs), then any under-recovery of costs from the Docklands developers and customers could be recovered from their existing customers elsewhere. Accordingly, a distribution business could be encouraged to require a lower contribution from the developer (or even to offer a financial inducement) in the belief that it is able to spread any under-recover of costs across its existing customer base.

Two problems may follow from these observations.

First, there would be no pressure for developers to select the lowest cost provider of distribution services in the Docklands. A high cost distribution business could 'win' the right to supply a precinct merely because it expected to recover the costs from its existing customer base, and so offered developers a low up-front contribution (or even an inducement). The effect of such an outcome would be that be that regulated distribution charges would be higher than necessary for customers taken as a whole.

Secondly, the pressure for distribution licensees to reduce the up-front developer contributions (or even to provide inducements) might lead to end-users in the Docklands being charged less than the long run incremental cost of providing their supply. This would be an inefficient pricing outcome and also could be seen as an inequitable outcome as (under rolled-in pricing) any shortfall in revenue from these customers would be recovered from the existing customers. Accordingly, the Office agrees with CitiPower's concerns that this sort of 'competition' may lead to inefficient pricing, at least if there is no further guidance about the future regulatory framework for the right to supply the Docklands.

It is noted, however, that it may be possible to align the incentives of the developers with the achievement of an efficient outcome by clarifying the basis of the ongoing regulation of electricity distribution services. A simple regulatory rule designed to achieve this result is examined next.

6.2.2 Clarifying the Future Regulatory Framework – A Mechanism to Align Incentives

The Office considers that a simple regulatory rule that would clarify the basis of future regulation in the Docklands and align the commercial incentives of the developers (and distribution businesses) with efficient outcomes would be to:

- include the Docklands area within the scope of the price control that applies to the regulated businesses of the relevant distribution licensee (that is, roll-in the Docklands with the existing system); and
- when setting the price control for the relevant distribution licensee, assign a zero regulatory asset value for all of the distribution assets within the Docklands that are not part of the trunk infrastructure.

For such a rule to work, performance requirements would need to be established and monitored for the Docklands as currently applies to the remainder of the networks. This would ensure that potential suppliers of electricity distribution services supply a comparable product and that there is effective regulation of quality after the assets

have transferred to the winning distribution business. This matter is discussed further in section 6.4.

In addition, a rigorous definition for 'trunk infrastructure' would need to be established. In principle, this definition should ensure that Powercor and CitiPower compete on equal terms for the provision of assets within the precincts, and should not distort the design of the distribution systems within the precincts. This matter is also discussed in section 6.4.

The effect of the 'simple regulatory rule' on the incentives for developers, and the implications for pricing in the Docklands, are discussed in turn.

Incentives to Select the Least-Cost Provider

Provided the ring-fencing measures discussed below are effective, this rule would preclude the distribution licensee for the precincts from recovering the cost of the distribution assets installed within the precincts through regulated tariffs. Accordingly, the distribution licensee would have to recover the cost of these assets from the developers, who in turn would be expected to recover these costs from property buyers as part of the price of the developed properties.[50]

The Office considers that this regulatory rule would operate to align the incentives of developers with the achievement of economically efficient outcomes. As developers would be required to pay for the distribution assets under this rule, they would have a strong incentive to minimise the initial capital costs involved. Moreover, developers may also have an incentive to select the distribution business that is likely to have lower ongoing operating and maintenance costs given that this would reduce future electricity prices (and hence raise the market value of the developed properties). This incentive may not be particularly strong, however, given that these costs would only be a small component of the net present cost of supplying electricity and (as noted above) developers may apply high discount rates to such future benefits.[51]

For these reasons, the zero asset valuation regulatory rule should lead to the distribution business being selected that can minimise the cost of the *distribution assets* that are installed within each precinct, and may provide some pressure for the ongoing operations and maintenance costs to be minimised.

However, on the face of it, there may be a potential concern that the rule would not necessarily result in the minimisation of the cost of distribution assets for the Docklands taken as a whole. That is, the resulting network design may not take full advantage of all potential economies of scope. This is because the rule would permit the selection of distribution licensees on a precinct-by-precinct basis that might not result in the realisation of all available economies of scope.

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[50] This rule for assessing the size of the developer contribution is a common practice in the provision of utility services. It was a practice of the SECV in some instances to require developers to provide the assets and gift them to the SECV, and this practice of developer contributions is still adopted by some (but not all) of the distribution licensees. The water industry also adopts this practice.

[51] As the Office will regulate prices in the future, it is able to permit only the efficient level of operations and maintenance costs to be recovered. In addition, Connell Wagner advise that future O & M costs seldom will change the rank of the various network options.

In practice, however, if there are economies of scope across the different precincts, then the first distribution licensee in the area should have a cost advantage in bidding for other precincts. As the developers have a strong incentive to select the lowest cost bid for providing the within precinct distribution assets, any distribution business that can take advantage of economies of scope should be preferred in the subsequent precinct bidding processes. In addition, there is nothing to preclude some or all of the developers from collectively selecting a single distribution licensee for their combined precincts. If there are economies of scope across the relevant precincts, then this action should reduce the cost that is borne by each of the developers.

In addition, any successful distribution licensee would be required to provide access services to other distribution licensees.[52] This would permit any subsequent distribution licensee in the Docklands precincts to obtain a right to interconnect with other distribution licensees. This, together with the developers' pressure for cost-minimising network configurations, should enable the available economies of scope to be realised even if multiple Docklands licensees emerge in practice.

6.2.3 Implications for Pricing within the Docklands

In the *Draft Decision*, the Office expressed a preference for determining regulated charges for the Docklands based upon the location-specific costs of supplying the Docklands. This would involve regulating the Docklands assets as stand-alone distribution systems.

However, as discussed in section 5.4 above, concerns were raised in submissions that regulating prices for the Docklands as a stand-alone system would raise administrative costs, and may also increase uncertainty about future prices. The Office has been persuaded to give weight to these concerns.

Accordingly, as with the regulation of the trunk assets, the Office has decided that the Docklands should be regulated under the price controls that apply (and will apply) to the remainder of the relevant distribution licensee's regulated Victorian electricity distribution business.[53] This would permit the licensee to charge the standard tariffs that apply to adjacent or nearby areas in the Docklands, or to set new tariffs specific to the Docklands area, subject to continuing to satisfy the price controls that apply to its Victorian distribution business as a whole.[54]

Under the regulatory rule described above, the winning distribution business would have to recover the cost of the non-trunk assets installed within the precincts directly from the developers, and so under any pricing rule, the developers would have the incentive to select the least-cost provider of these assets. In addition, as the cost of the

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52 As discussed in section 3 above, the existing licences impose these access obligations. If new licences are issued with regard to the supply of distribution services within the Docklands, similar provisions will be included in those licences.

53 If an interstate distributor is selected to provide electricity distribution services for a precinct, it would be regulated on a location-specific basis because the Victorian regulatory framework and the Office's jurisdiction does not extend to interstate distribution networks.

54 The distribution licensees currently have the ability to set geographically-based network tariffs within the price control and re-balancing constraints discussed in section 3.1, and Powercor already has set a number of geographically-based tariffs.

within-precinct (non-trunk) assets will be excluded from the regulatory asset bases for the companies, it is unlikely that rolling-in the Docklands business could result in the existing customers cross-subsidising the Docklands customers (rather, rolling-in is likely to provide a benefit to existing customers). Lastly, if the relevant distribution licensee is concerned that its existing standard tariffs may leave customers susceptible to by-pass in the Docklands, then it has the flexibility to determine Docklands specific tariffs that alleviate this threat (within the constraints of the price control restriction).

Connection Charges / Customer Contributions

CitiPower has commented that a decision by the Office to licence Powercor (and any other distribution business) for the Docklands appears to imply that the Office considers CitiPower's methodology for determining connection charges to result in inefficient prices. CitiPower has also suggested that this would seem to imply that the Office has misunderstood CitiPower's approach to determining connection charges.

As discussed in section 6.3 below, the Office's decision to permit competition for the right to supply electricity distribution services within the Docklands precincts is based primarily on a view that this will lead to a reduction in the cost of the relevant distribution assets (that is, an improvement in the level of productive or technical efficiency). Nevertheless, some discussion on the implications for efficient connection pricing is warranted.

As described in section 4.2.2 above, a key criterion for allocatively efficient prices in the presence of natural monopolies is that prices deliver revenue, on a per customer basis, that is:

- greater than the *incremental cost* of providing service to, or the *avoidable cost* of continuing to serve, that customer; and
- less than the *stand alone cost* of providing the service by the most efficient means.

These two bounds for efficiency of prices are generally referred to as the lower and upper bounds respectively.[55] However, the range of prices that fall within these efficiency bounds can be quite wide.

CitiPower's current connection charging regime (which CitiPower has stated would apply to the Docklands) appears to be *intended,* in broad terms, to have the following effect:

- customers pay the full cost of any assets that are dedicated to their supply, such as meters and services; and
- in relation to shared assets, a connection charge is levied where the incremental cost associated with connecting that customer exceeds the incremental revenue, and no connection charge is levied otherwise.

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[55] For residential and many commercial customers, it is difficult to envisage the upper bound being exceeded given the economies of scale and scope in electricity distribution. Accordingly, the lower bound constraint is the more relevant for efficient pricing.

Provided the charging methodology is implemented in line with the objectives and the assumptions made when calculating the connection charge are borne out in practice, this methodology should result in new customers bearing at least the incremental cost associated with providing their service.[56] This would hold regardless of the future tariff level: if tariffs were high, connection charges would be low, and vice versa. Accordingly, this rule would be expected to result in the lower bound efficiency condition being met.

Under the simple regulatory rule that is proposed for the Docklands, developers in the Docklands (and ultimately the customers) would pay for all of the non-trunk assets that are installed within the Docklands precincts. After service has commenced, the customers would then pay the applicable tariff, which could be the standard tariff from surrounding areas, or a Docklands-specific tariff (as explained above). Given this up-front contribution, it is difficult to envisage these customers not contributing at least the incremental cost of providing their service or paying more than the stand-alone cost of providing its service.[57]

Accordingly, both the CitiPower connection charging rule, and the 'zero regulatory value rule' described here, should lead to the charges within the Docklands being within the lower and upper bounds for economic efficiency. As noted above, the range of prices that might fall within these bounds can be quite wide.

6.3 Comparison of the Alternative Options

The Office considers that providing a choice of licensed distributors from which developers can select the distribution licensee or licensees to provide the distribution services within the Docklands has significant advantages over the 'CitiPower option' which involved not licensing any other distribution business (and ensuring in practice that CitiPower remains the sole distributor in the Docklands). However, this conclusion is subject to the simple regulatory rule discussed above being adopted and the future regulatory framework for the Docklands distributors being specified in those terms.

The main advantages of the developer selection option implemented on this basis are as follows:

- it permits (and provides strong incentives for) the developers to select the lowest cost provider of the distribution assets within the Docklands precincts on a

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[56] The Office has not assessed whether CitiPower's connection charging methodology as implemented meets these objectives. The Office intends to undertake further work on connection charging methodologies in the context of the 2001 Price Review.

[57] CitiPower also commented in its submission on the *Draft Decision* that the Office's proposed connection charging rule would impact on the already frail economics of the Docklands. The Office does not consider there to be a serious possibility that the connection charging rule for the Docklands could make the difference between the Docklands projects being viable or non-viable given that the cost of the intra-precinct electricity infrastructure would only be a very small fraction of the total cost of the development. In addition, as noted elsewhere, the ability for a developer to choose between providers of distribution assets may well provide substantial benefits to the developers through a reduced risk that the electricity distributor could delay the project (where the cost of such a delay would be an increase in financing costs for the whole project).

competitive basis, (whereas the 'CitiPower option' would simply involve the Office accepting that CitiPower is likely to be the lowest cost provider with no competitive option being available to developers);

- it facilitates competition in the design, construction and operation of the assets, thus extending the reach of competitive discipline and may therefore encourage innovation in the provision of this service; and
- the requirement to compete for the right to provide the distribution services is likely to make the distribution businesses more responsive to the needs of the developers and to those of end-users.

The penultimate point above is important as it implies that the reach of the competitive discipline would be extended. As a number of submitters noted, competition in *construction* is already a feature of the existing regulatory regime and so cannot be counted as an additional benefit. However, it normally would be the case that the incumbent would either design or exercise a heavy influence on the design of the system for a new development. In contrast, the developer-selection option also throws open the design of the system to competition. As Dennis Projects commented in its submission on the *Draft Decision*:

> *"[T]he practice has emerged whereby the service provider, whose area the development is situated, sets the standards, and in most cases carries out the design and then approved the design. The developer then arranges and pays for the construction. The developer has no way of knowing if the capital works are gold plated to reduce recurrent costs, and even if it did, it has little chance of seeking modification."*[58]

The Office has received complaints in the past about the responsiveness of distribution businesses to the needs and time lines of developers. While the Office makes no comment about the veracity of such claims, it is noted that unnecessary delays to a project will increase the associated financing costs. Accordingly, a process that provides developers with scope to enter into an arrangement with a distribution business that minimises the chance of such a delay is likely to deliver tangible (and possibly substantial) benefits.

The Office is keen to explore options for expanding the role of competition, for reducing the scope of regulatory decision-making and for promoting more efficient outcomes. The Office believes that the option for introducing network competition into the Docklands that has been proposed in this section will harness the forces of competition, while also ensuring that the competition directs the incentives of the market participants towards producing economically efficient outcomes At the same time, adoption of this model for the Docklands does not foreclose the role of competition in relation to inset licenses being expanded in the future.

6.4 Implementation Issues

There are a number of matters (some of which were identified above) which require resolution in order to implement the Office's preferred option for selecting the

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[58] Dennis Projects, *Re: Application by Powercor for a Licence to Distribute Electricity in the Docklands Draft Decision* June 1999, 16 July 1999, Page 1.

distribution licensee for the Docklands precincts. The matters that require resolution include the following:

- the specification of performance benchmarks for the Docklands;
- the rule for determining which assets are to be treated as trunk and which are intra-precinct (non-trunk) assets for the purposes of price review forecasts and regulatory accounting;
- the treatment of the TUOS equalisation adjustment; and
- the identification and resolution of potential ambiguities in the various regulatory instruments that apply to the electricity distribution businesses.

These issues are considered in turn.

6.4.1 Performance Benchmarks and Targets for the Docklands

In keeping with the Office's approach to regulating service quality for the 2001-5 period, the Office will specify minimum benchmarks for the reliability of electricity distribution services within the Docklands and will require Docklands distributors to specify reliability targets. The Office will assess the adequacy of those targets with reference to the benchmarks. The specification of such benchmarks will provide the developers with a mechanism to assess bids on an equal (ie same-service) basis.

The Office intends to protect the interests of end-users by monitoring the actual reliability of supply to the Docklands and comparing it with the distributor's targets and the Office's benchmarks. Should this monitoring reveal significant under-performance attributable to a breach of the 'good asset management' provisions of the *Distribution Code*, the Office would have power to take enforcement action. The Office will also have power to reduce the distributor's regulated revenues at subsequent price reviews in response to under-performance.

Developers would be free to request bids on the basis of satisfying targets which exceed the reliability benchmarks, and the Office would enforce any such agreed targets. However, the Office would expect that developers would ask all bidders to submit a costing for the benchmark level of service and a second bid for any higher level of service to ensure that the costs of the higher level of service are transparent.

The Office will publish its performance benchmarks for the Docklands in the near future.

6.4.2 Definition of Trunk and Intra-Precinct (Non-Trunk) Assets

A definition of trunk and non-trunk assets is required to implement the simple regulatory rule specified in 6.2.2. One objective is to ensure that, when offering competing bids for the provision of intra-precinct assets, Powercor and CitiPower are in competitively neutral positions. This requires each business to be permitted (subject to an efficiency test) to roll-in commensurate forms of assets, and therefore to require each business to charge developers for commensurate forms of assets. A second objective is to ensure that the definition of what can and cannot be rolled-in to the regulatory asset base minimises any distortion to the design of the distribution system. Thus, the definition should not encourage distribution businesses to extend trunk

assets up to customer connection points purely because those assets can be rolled-in to the regulatory asset base.

In the *Draft Decision*, the Office proposed distinguishing between the trunk and non-trunk assets on the basis of voltage, and proposed that non-trunk assets were to be those that operated at a voltage of less than 11 kV. Since releasing the *Draft Decision*, however, the Office has received advice that some assets that operate at greater than 11 kV are likely to be used for intra-precinct assets and will not perform a trunk function. In addition, the Office considers the definition proposed in the *Draft Decision* might encourage the use of relatively more 11 kV assets within the precincts purely because these assets can be rolled in to the regulatory asset base (subject to an efficiency test).

After taking advice, the Office now considers that the distinction between trunk and non-trunk assets should be made on the basis of function and capacity. The definition that the Office intends to adopt in making that distinction is as follows.

Trunk assets include subtransmission assets, and high voltage (HV) underground cables and switching stations in "ring" or "mesh" configuration, provided that:

- any switching stations are connected to at least two sources of supply, from either separate zone substations or separate busbars of the same zone substation, such that they can provide continuity of supply to the trunk "ring" or "mesh" in the event of an outage of a single interconnecting cable;
- any HV underground cables are in "ring" or "mesh" configuration and have a design capacity, taking account of any distribution cyclic loading conditions, of at least 4 MVA at 11 kV or 8 MVA at 22 kV;
- the assets operate at 11kV or higher; and
- the assets, including station service transformers at switching stations, do not supply any customer directly.

Note that:

- transformers with a secondary voltage of less than 11kV are not trunk assets;
- switching stations are high voltage switches or circuit breakers; and
- the point of connection of a "non-trunk" asset to a trunk asset is via an outgoing cable box on a circuit breaker or switch in a zone sub-station or trunk switching station.

As this definition of the distinction between trunk and intra-precinct assets has not been the subject of public comment in the Office's consultation processes on this matter, comments are being invited before the Office reaches a final view on the definition. Comments on the proposed definition of trunk infrastructure assets are invited by close of business Tuesday 26 October 1999.

In order to ensure that the "zero value" rule for intra-precinct assets described above is implemented on the basis required, the Office will take steps to ensure that the above definition of trunk assets is applied in practice by distribution businesses that are licensed to operate in the Docklands. This action is necessary to ensure that these licensees are prevented from including in their regulatory asset bases any investments in intra-precinct assets which they may seek to describe as trunk assets.

To achieve this, it is proposed that, following the period of consultation, the final definition will be incorporated into the Office's *Electricity Industry Guideline No. 3* (on the form and content of the distributors' regulatory accounts) and into the Office's requirement for forecast information to be included in the data templates for the 2001 Electricity Distribution Price Review.

6.4.4 TUOS Equalisation Adjustment

The TUOS equalisation adjustment scheme is prescribed in clause 4.3.1 and Attachment 7 of the *Tariff Order*. Under that arrangement, a *standard* transmission charge (referred to as the transmission use of system charge, or TUOS) is calculated for each of the electricity distribution licensees.[59] An upward adjustment is made to the charges for the urban electricity distribution licensees (CitiPower, United and AGL) and a downwards adjustment is made for the rural electricity distribution licensees (Powercor and Eastern Energy), where the positive and negative adjustments exactly offset. It is understood that the intention of these adjustments was to increase the average network charges in respect of urban customers, and reduce the average network charges in respect of rural customers, and so encourage a greater degree of tariff equalisation across the state.

In the *Draft Decision*, the Office noted that, on the face of it, the fact that the urban distribution licensees appear to bear a TUOS-tax and rural distribution licensees appear to receive a TUOS-subsidy suggests that Powercor (a rural distribution licensee) might have an artificial advantage over CitiPower (an urban distribution licensee) in supplying the Docklands. The *Draft Decision* also noted that a portion of CitiPower's equalisation adjustment might be attributable to the Docklands demand and that, in fairness, this portion of the equalisation adjustment should be borne by whichever distribution licensee serves the Docklands business.

In considering the implications of the TUOS equalisation adjustments for the matter at hand, however, it is important to consider the detailed operation of the scheme. Two observations about the operation of the scheme are relevant.

- First, the implied transfers from the urban distribution businesses to the rural distribution businesses are fixed (lump-sum) transfers. That is, they are independent of the energy (kWh) sold, customers served, or any other variable. Thus, if Powercor supplies customers in the Docklands, its implicit receipts under the scheme are unaffected. Similarly, if CitiPower fails to secure customers in the Docklands, its implicit payments under the scheme also are unchanged. Accordingly, the scheme cannot affect the incremental cost that each business will incur in supplying customers in the Docklands, and so the scheme cannot give rise to competitive neutrality problems.
- Secondly, the equalisation adjustments are made to the TUOS charges that are paid by each of the electricity distribution licensees. The electricity distribution licensees, however, pass on the *adjusted* TUOS charges fully to customers through their network charges (the Office approves a network charge annually for the electricity distribution licensees which recovers the sum of the approved DUOS and TUOS charges). Therefore, the TUOS equalisation scheme has no implications for the distribution licensees – their liability is passed-through directly to customers, and so all of the impact is borne by customers.

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[59] The 'standard charge' for each electricity distribution licensee is calculated by allocating GPU's annual regulatory costs to each of the electricity distribution licensees on the basis of a cost allocation algorithm that is described in Attachment 8 of the *Tariff Order*.

However, if the intention of the designers of the scheme was to be preserved then, in principle, a variation to the TUOS equalisation adjustments for the different licensees would appear to be justified. That is, if the equalisation adjustments were derived on the assumption that the Docklands revenue would flow to CitiPower, but part or all of this revenue is received instead by Powercor, then the intended effect of the equalisation adjustment would be preserved were Powercor to 'pay' the portion of the equalisation adjustment that was attributed to the demand in the Docklands. The effect of this would be to reduce the upward adjustment to the TUOS charges that are passed on to CitiPower's customers, and also reduce the downward adjustment to the TUOS charges that are passed on to Powercor's customers.

Against this, however, the Office notes that the materiality of this issue and the practicalities of making changes to the TUOS equalisation adjustments also need to be considered. The following matters are relevant in this regard.

- First, it is unlikely that the change required to the equalisation adjustment would be material. The analysis undertaken by the Office suggests that, given plausible assumptions about how the equalisation adjustments were calculated, it is difficult to see that the forecast demand in the Docklands could have accounted for more than 3 per cent of CitiPower's equalisation adjustment. As CitiPower's annual equalisation adjustment is just under $6 million, the adjustment attributable to the whole of Docklands might be in the range of $180,000. If Powercor only takes a share of the market, then the required transfer from Powercor's customers to CitiPower's customers would be a corresponding fraction. When spread across all of the customers of CitiPower and Powercor, this figure is unlikely to have a perceptible impact on uniform tariffs.
- Secondly, the equalisation adjustments were calculated on the basis of a large number of assumptions about the future, many of which inevitably will not have been borne out in practice. It would be inconsistent to change the TUOS equalisation adjustments to reflect actual outcomes in relation to some assumptions (eg which future markets are ultimately served by which licensee) but not to change the adjustments to account for other potentially more significant differences between the assumptions and subsequent outcomes (such as the difference between forecast and actual system demand).
- Thirdly, regardless of the above, it is doubtful whether the Office would have the power to alter the TUOS equalisation adjustments because they are enshrined in the *Tariff Order* which the Office does not have the power to alter. Similarly, any scheme to offset the effect of the equalisation adjustments would require a tax to be imposed on one group of customers, and the revenue transferred to other customers. The Office, however, has no power to implement such a transfer.

For these reasons, the Office's current view is that a change to the TUOS equalisation adjustments would not be warranted if a distribution licensee other than CitiPower were to supply customers within the Docklands.

6.4.5 Potential Ambiguities in the Existing Regulatory Instruments

Ambiguities may arise in the interpretation of certain regulatory instruments that currently apply to the electricity distribution licensees if a new licence is issued to Powercor with respect to the Docklands. Concerns have been raised by CitiPower in

relation, in particular, to issues under the *Distribution System Code* (concerning public lighting) and *Retail Tariff Metering Code* (concerning metering provision).

The Office has received advice that it has power to deal with these concerns, given its power to amend industry codes. The Office would welcome input from CitiPower, Powercor and other interested parties as to how it might best address these concerns. The Office does not consider, however, that they are sufficiently serious to warrant deferring the grant of a licence to Powercor.

Powercor has accepted that any grant to it of a distribution licence with respect to the Docklands area should not carry with it a right to sell electricity to franchise customers in the Docklands area. Given this, the Office proposes that the rights of Powercor under its distribution licence with respect to the Docklands be conditional on Powercor agreeing to any amendments to its retail licence which the Office considers necessary or desirable to address this issue.

6.5 Conclusion on Licensing and Regulation within Docklands Precincts

For the reasons advanced in this section, the Office has decided to issue Powercor with a licence to provide electricity distribution services in the Docklands precincts.

The Office expressed a view in the *Draft Decision* that it would be appropriate to issue a new (separate) licence to Powercor for the Docklands. Given Justice Eames' comment in *CitiPower Pty vs Office of the Regulator-General and Powercor Australia Ltd* that issuing a new licence would be more appropriate,[60] the Office sees no reason to depart from its earlier view.

The Office intends Powercor's licence to extend the existing regulatory regime (including the existing price control) to cover the services provided by Powercor within the Docklands.

Prior to issuing the requested licence the Office needs to be satisfied that Powercor has the technical capacity to comply with the conditions of its licence. The Office is satisfied of this. Powercor's technical capacity is evidenced by operations of its existing distribution system. While Office oversight of those operations has, as with the other distributors, revealed areas for improvement, there has been nothing to suggest a lack of technical capacity. While CitiPower has raised technical concerns as to Powercor's design of the trunk infrastructure, there has been no suggestion that Powercor does not have the required technical capacity.

While the Office cannot prejudge the position that it will take with respect to other applications for licences to provide electricity distribution services by means of infrastructure that is situated within the Docklands area, at this time the Office considers that it would be consistent with the Office's objectives (discussed in section 3 above) to:

- issue licences to other suitably qualified applicants to provide electricity distribution services within the Docklands area; and

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60 [1999] VSC 348

- insert conditions within such licences (if necessary) to apply the same regulatory regime as that which applies to Powercor.

7. THE OFFICE'S FINAL DECISION ON THE POWERCOR DOCKLANDS LICENCE APPLICATIONS

The Office has decided to issue a new licence to Powercor to enable Powercor to provide electricity distribution services within the Docklands area. The Office will ensure that the regulatory regime (including the existing price control) that applies to Powercor's existing regulated business would apply to any electricity distribution business it undertakes within the Docklands.

While the Office reserves the right to vary the methodology ultimately used to determine relevant tariffs as part of the next or any subsequent electricity distribution price review, the Office currently intends to deem a regulatory asset value of zero for any non-trunk assets that are installed within the Docklands precincts by any distribution licensee. The Office's proposed definition for distinguishing between trunk and non-trunk assets is provided in section 6.4.2 above. As discussed in that section, the Office invites comments from interested parties on that definition by 26 October 1999. Having considered any comments, the Office will implement its final definition of trunk/non-trunk assets through an appropriate change to the regulatory accounting guidelines and its requirements for the 2001-5 distribution price review.

The Office will apply the minimum reliability benchmarks foreshadowed in section 6.4.1 above when assessing the reliability targets proposed by the licensees and the actual performance of the licensees in the provision of distribution services within the Docklands.

The performance of Powercor's Docklands assets will be regulated under the performance monitoring regime that applies generally to the Victorian electricity distribution licensees. That is, Powercor will be responsible for designing and installing infrastructure that provides efficient and reliable distribution services to the Docklands precincts it serves. The Office's role is to monitor and report on the performance of the distribution networks and to take remedial action when the performance provided does not meet the licence requirements.

The Office does not intend, at this stage, to make adjustments to TUOS equalisation arrangements in the light of this decision to issue a new licence to Powercor enabling it to provide electricity distribution services in the Docklands. Its reasons for adopting this position are set out in section 6.4.4 above.

The common seal of the Office of the)
Regulator-General was affixed pursuant)
to the authority of the Office on)
13 October 1999.)

[signed by JOHN C TAMBLYN]

JOHN C TAMBLYN
Regulator-General

ATTACHMENT: PUBLIC CONSULTATION PROCESS

A.1 Consultation Process

In June 1998, a *Discussion Paper* was published and submissions sought from all interested parties.

The *Discussion Paper*[61] proposed a general framework for assessing applications for inset licences. The Paper provided details of Powercor's application, and sought comments on Powercor's application in light of that framework.

A number of the public submissions made after the release of the *Discussion Paper* and the further analysis by the Office suggested that some form of continuing regulation of the inset licensee normally would be required. This is because a distribution licensee normally would be in a position to exercise market power.

In light of this, the Office formed the view that it would be inappropriate to make a decision on this inset licence without considering whether some form of regulation of the inset licensee would be required once the licensee begins to provide service and, if so, the form of the regulation. Amongst other things, it was considered that the particular competitive disciplines and/or regulatory arrangements that applied in the future could influence the decision as to whether the issuing of an inset licence were consistent with the Office's objectives (as outlined in section 3 above). As a more practical issue, if the inset licensee were to be regulated after the issuance of a licence, it was considered that it would be desirable to have this regime imposed as a condition of the inset licence rather than applied as a licence amendment after the event.

As the Office had not consulted directly on these issues previously, it released a *Pre-Decision Consultation Paper* in April 1999[62] in order to provide interested parties with the opportunity to comment on these issues prior to issuing the *Draft Decision* on the licence application. That *Draft Decision* was released in June 1999, and a further round of submissions received.

Where relevant, the points made in the public submissions are discussed in the appropriate part of section 4 of this *Draft Decision*. However, for completeness, the major points raised in each of the submissions (by author) are summarised below. The full versions of most of these submissions are available on the Office's web site www.reggen.vic.gov.au.

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61 Office of the Regulator-General, *Powercor's Application for a Variation to their Distribution License to include the Docklands Area: Discussion Paper*, June 1998.

62 Office of the Regulator-General, *Application by Powercor for a Licence to Distribute Electricity in the Docklands: Pre-Decision Consultation Paper*, April 1999.

A.2 Summary of Submissions in Response to the *Discussion Paper*

Powercor's application and submissions[63]

Powercor submitted in support of its application that the provision of electricity distribution infrastructure to the Docklands would be a greenfield project for which an inset distribution licence should be permitted. The company defined a greenfield project to be one *"where a development is in a clear site with a defined boundary, does not result in significant stranded assets, and will result in a viable stand-alone network"*. According to Powercor, a greenfield area should be large enough to yield economies of scale and scope. As a guideline, it considered that such economies would occur where loads exceed 50 MW, which was easily satisfied by the Docklands.

The greenfield area should be a logical unit of the network in that it should have a separate independent sub-transmission connection to a zone substation.[64]

Powercor considered the Docklands to be a greenfield area because:

- there will be no significant stranded assets in the area, as the site is being substantially cleared;
- any assets presently on the site are designed for very limited loads and will be obsolete;
- completely new infrastructure will be required to meet the new loads; and
- the company's network design is for a stand-alone, highly efficient distribution network.

The company suggested that its proposal would involve construction of a *"state of the art"* electricity distribution system, which will be exceptionally reliable and efficient. The 22KV distribution line will link directly into the transmission network, which is said to *"minimise the exposure of the system to faults on the sub-transmission network"*.

Importantly, the submission noted that:

> *"Powercor has represented to the Docklands Authority that the 'preferred option will result in initially lower Network Tariffs and a better long term price path for the consumers'. Powercor intends that its network prices in the Docklands area will initially be lower than CitiPower's standard network tariff."*[65]

In its later submission the company indicated only that its network tariffs *"would be less than or equal to the current relevant tariffs of CitiPower"*.

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63 Powercor Australia, "Application for Variation of Distribution Licence"; 4 March 1998, "Application for Licence Variation for the Docklands Area: Additional Information", 18 September 1998; and letter to the Office dated 28 September 1998.

64 Powercor, Application, 4 March 1998.

65 Ibid.

Powercor further supported its proposal by suggesting that it is a requirement under the *National Electricity Code* (NEC) to allow for efficient by-pass of networks. Further, it was consistent with the objectives of the Office under the *Electricity Industry Act* and the *Office of the Regulator-General Act*. Powercor suggested approval of the application was necessary if the competitive tendering process for Docklands infrastructure was not to be frustrated; the proposal would be efficient; and consumers would be protected by tariff regulation and by potential competition from the incumbent. Powercor claimed that CitiPower's financial viability would not be affected because the Docklands is a new site, but its market power from being the only distributor would be undermined, and new entry in the form of Powercor would be facilitated if the application was approved.

Powercor's response to the submissions by other parties and to questions raised by the Office reiterated many of the points made in its application and provided details of its proposed capital expenditures on a confidential basis. Powercor agreed with many of the general points on inset appointments made by the Office in its *Discussion Paper*. In particular, it agreed that the Office had a role to ensure that there was not unnecessary duplication of infrastructure. In the present case, however, it suggested this would not occur as the Docklands is a greenfield site and economically useful assets of the incumbent would not be stranded.

CitiPower's submissions[66]

CitiPower provided an initial submission, three supplementary submissions and a further submission responding to other submissions. The company expressed strong opposition on legal, technical and economic grounds to the application to vary Powercor's licence stating that:

> *"[I]t has at all times been and remains the position of CitiPower that it and it alone is entitled to distribute electricity in the Docklands area. That was one of the bases upon which CitiPower was sold. Representations were made at the time that CitiPower was sold that it alone would distribute electricity in the Docklands area and those representations were relied upon."*[67]

CitiPower also stated that:

> *"[I]t is not within the power of the Office of the Regulator-General to vary the Powercor licence to authorise it to distribute electricity in the Docklands area and that the form and procedure adopted in relation to the decision of the application to do so do not facilitate such a variation."*[68]

Attached to the company's submission were confidential materials which the company argued demonstrated that the Docklands area had been factored into long-term load and capital expenditure forecasts at the time of its privatisation and that the

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66 CitiPower, "Responses to Powercor's Application for a Variation to its Licence (to include the Docklands Area)", 13 July 1998; Supplementary Submission Number 1, 6 August 1998; Supplementary Submission Number 2, 19 August 1998; Supplementary Submission Number 3, 21 August 1998; and "Response to Powercor's Submission Dated 18 September 1998, 19 October 1998.

67 CitiPower, Responses, 13 July 1998.

68 Ibid.

Tariff Order had allowed for certain expenditures and loads relating to Docklands. Whilst this material is not inconsistent with the claim that CitiPower was intended to have monopoly rights to supply of the Docklands, the Office does not consider that it is proof of this claim. Indeed, it could be consistent with a contestable market situation where the company, if pricing efficiently, might expect to obtain the bulk of expected new sales.

CitiPower considers that the Docklands is not a greenfield site as claimed by Powercor. It suggests a more restrictive definition of a greenfield site should apply such that only undeveloped virgin land whose potential has not previously been recognised or specifically included in a regime and which is not closely linked to surrounding areas should be covered by the term. Importantly, it suggests that the Docklands:

> *"is already fundamentally integrated within the CitiPower distribution network. Powercor's assumption that the site will be substantially cleared (of electrical assets) is not possible and suggests a misunderstanding of CitiPower's existing assets in the area that supplies customers both in and surrounding the precinct".*[69]

The submission describes in detail the assets CitiPower has in the Docklands and surrounding area and the integration of these assets into its total distribution network. The company's approach has been to augment the distribution system incrementally to the area to meet load growth over time. It currently has 48 distribution customers in the Docklands with a recorded load of 6.1MW. It suggests that there is a need to integrate fully the development of the Docklands electricity distribution infrastructure with other nearby major electrical loads including the CBD, Southbank and the Melbourne Ports area. It commented that:

> *"Electrical infrastructure for the Docklands area must be designed in conjunction with the future requirements of these important loads. A piecemeal segmented approach will not only be sub-economic but could produce dire consequences in terms of security of supply."*[70].

CitiPower questions the appropriateness of the use of the 22KV link by Powercor rather than the standard CBD voltage of 11KV. It considers that it is better placed in this regard. It commented that:

> *"CitiPower, having multiple 11KV supply sources close to the load centre and with no voltage drop problems, has then opportunity to augment the existing system while maximising operational flexibility by interconnection with adjoining areas to transfer loads."*[71]

Powercor's approach, in its view *"is poor engineering practice"*. It involves higher up-front capital expenditures on construction of the zone substation and the 22KV link than the alternative, which would allow future load requirements for many years at least to be met from existing zone substations. Moreover, CitiPower considers that supply by it would be more reliable and have more load shifting flexibility than is the

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69 Ibid.

70 Ibid.

71 Ibid.

case with the Powercor proposal which has a single point of supply and is more isolated from the existing distribution system. It is also claimed that power supply quality would be more variable if it relied on the single source proposed by Powercor.

CitiPower provided confidential financial evaluations it had prepared comparing its approach to the development of electricity distribution infrastructure in the Docklands with that of Powercor. Largely because of the earlier timing of Powercor's assumed capital expenditures, the results suggested that the CitiPower option was $5.5m-$7.0m less costly. In a supplementary submission[72], the company also provided financial estimates relating to a third option where Powercor supplied the Yarra Waters and Victoria Harbour precincts, closest to the FBTS supply point, and CitiPower the remaining precincts. It concluded that this was still around $4.8m (28%) more costly than monopoly CitiPower supply.

CitiPower took issue with Powercor's claim that: *"By its selection, the Docklands Authority is satisfied that the service to be provided is equal, or better, in quality and price to that offered by competing suppliers"*. It suggested that:

No rules or criteria were put in place, or assessments undertaken, by the Docklands Authority to determine this in relation to electricity distribution.[73]

The submission argues generally that distribution networks are natural monopolies and should be regarded as exclusive. Network competition where a network is already covered by regulated tariffs will, in CitiPower's view, produce unsatisfactory outcomes. The company suggested that the promotion of competition in distribution was not an objective of the *Electricity Industry Act*. An objective of this Act is to promote competition in the sale and supply of electricity. The words sale and supply should in its view be read to refer only to retail.

The company argued that the Government determined the optimum size of the distribution monopolies taking into account its privatisation objectives. It suggested there would also be significant difficulties in regulating a smaller area like the Docklands due to greater forecasting uncertainties. However, the submission acknowledged there were some cases where inset developments may be appropriate, such as airports or major enterprises.

These situations can only be judged on their particular merits. The relevant criteria may include the number of customers involved, whether they are capable of negotiating terms and conditions for both connection and ongoing charges, whether the network is relatively discrete and is not significantly intermeshed and finally, ideally, a situation characterised by a need not to regulate.[74]

The submission also points to the role of regulation in ensuring appropriate cost and price outcomes. The importance of ensuring correct price signals for connection is stressed together with the ability to have tendered out the connection works. CitiPower suggests that allowing competing distributors in the one area would

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72 CitiPower, Supplementary Submission Number 3.

73 CitiPower, Responses 13 July 1998.

74 Ibid.

undermine efficient pricing arrangements as prices would be reduced for connection, and cross-subsidies between areas may occur.

AGL Electricity[75]

AGL Electricity indicated that it: "*is generally supportive of competition in the provision of electricity networks*", but only where there is real benefit to customers and no detriment to existing customers of the competing distribution businesses. An inset licence should only be allowed on the basis of customer benefit, which should take into account more than just tariffs. In this regard it may not be the case that a developer of a site would base a decision about electricity distribution infrastructure on long-term cost and reliability to all customers.

AGL considered there was a need for regulation to protect proposed and future customers in an inset area to ensure customers do not pay more than they would have with the incumbent and that customers in the inset area were not subsidised. Comparisons of proposed charges with existing network charges needed to be corrected for any existing cross-subsidies. The company suggested that incumbents should be given a choice of being compensated for stranded assets or being able to leave them in place to compete. Compensation should be based on net present value or depreciated replacement cost, including any excess capacity, and be paid in a lump sum.

United Energy[76]

United Energy in its submission advocated the development of competition in the provision of network services providing this was not distorted by existing tariff regulation.

> "*United Energy believe that the opportunity now exists to develop a competitive market in distribution, and as such, given the government reform policy and the ORG's objectives, there is no reason to let this opportunity go by.*"[77]

The company's preferred approach is to remove pricing distortions now in place as a result of tariff averaging, adjustments made to asset values and tariffs at the time of privatisation to maintain rural cross-subsidies, and adjustments to transmission charges made to the same effect. Removing restraints on tariff re-balancing could do this and by ensuring new entrants to metropolitan distribution areas incurred similar rural subsidisation costs as incurred by the incumbents. Further "*where these charges will be paid by the incumbent (or have already been paid), those costs should be in the form of a reimbursement to the incumbent*".

The company was of the view that tariff regulation for inset areas was not necessary although tariffs should be subject to a fair and reasonable test, as for excluded services, and could be monitored against a range of benchmarks, including the equivalent tariff of the host distribution business. Where distributors had not negotiated directly with end-customers, it was recognised that there was a case for

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75 AGL Electricity, Letter to Office of the Regulator-General, 10 July 1998.

76 United Energy, "Docklands Submission", 16 July 1998.

77 Ibid.

stronger regulation than otherwise. It was suggested that new entrants should be precluded from cross-subsidising between the inset and their existing network, technical issues such as reliability standards, network interconnection and the efficient introduction of new technology needed to be taken into account, and the Office needed to recognise the higher risk associated with stranded assets under competition.

United Energy proposed a decision framework for evaluating inset licence applications that recognised the likelihood that pricing distortion would continue to exist for some time. The framework distinguished 'greenfield' inset areas, where there was no risk of stranded assets, from 'brownfield' inset areas, where there was a risk that an incumbent's assets would be stranded by an inset appointment. It would be up to the parties to demonstrate whether or not stranded assets would occur and whether the assets involved were inappropriate, immaterial or otherwise inadequate. It would also be necessary to show whether the incumbent had an opportunity to bid for the supply and that the tariffs and service offerings were fairly compared, and to consider whether the applicant's system development design is appropriate for now and into the future. If it can be shown that pricing distortions exist as a result of government or regulatory requirements which penalise the incumbent, compensation should be payable from the applicant for the unfairly stranded assets. Finally, "*if the combined cost of the applicant's inset tariff and any deemed compensation for government imposed equalisation mechanisms on the incumbent are less than the cost of providing the service, the application should be approved.*"

United Energy applied its framework to the Powercor application relating to the Docklands, but concluded that it had insufficient information on the matters noted above to make an assessment.

The Australian Cogeneration Association[78]

The Australian Cogeneration Association (ACA) suggested that:

The issue of inset networks goes to the very heart of competition in the electricity industry. A comprehensive, rational and fair regulatory policy on inset development can provide a sound mechanism to ensure that competition is possible in provision of network services. Such a policy would reduce the obstacles faced by embedded generators, cogenerators, greenfield site developers and other customers in negotiation of fair and reasonable terms and conditions for supply or for competition to established network assets. In particular, it would allow fair negotiation of connection conditions affecting standby, backup and legitimate transfer of locational benefits created by embedded generators.[79]

ACA therefore argues that inset appointments should be permitted wherever they are supported by a network customer, irrespective of whether they relate to a greenfield site or to by-pass situations where assets of an incumbent are stranded. It suggests that this is not much different to the situation, which already exists, where customers have a right to reconfigure their supply, select the tariff they are supplied at, and where

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78 Australian Cogeneration Association, "Inset Developments: Promoting Competition in the Electricity Industry", Response to Office of the Regulator-General's *Discussion Paper*, July 1998.

79 Ibid.

some customers are exempt from regulatory arrangements. ACA considers that ensuring a right to by-pass would encourage commercial negotiation and result in stronger competition at the margin and pressures for efficiency. If regulation is to occur, it favours adoption of an approach to inset appointments which is similar to, though more light handed than, that of OFWAT, the economic regulator for water in the UK. OFWAT encourages inset appointments providing they exceed a threshold size. It allows incumbents to respond to the threat of by-pass by non-discriminatory price changes and it does not require that compensation be paid for stranded assets of incumbents.

ACA supports Powercor's application on the basis that this is the preferred option of the customer, the Authority. It agrees that Powercor's proposal will provide a "state of the art" distribution system. It does not support compensation being provided for any stranded CitiPower assets that may result from approval of the Application.

The Institute of Public Affairs[80]

The Institute of Public Affairs (IPA) advocated maximising the opportunity for competition and minimising the role of regulation in the industry. IPA considers that by-pass should be automatically allowed and dual supply to an area permitted. The Powercor proposal is seen as promoting competition. IPA has little concern over the process by which the inset application came about or the impact its approval may have on the incumbent. It also sees no need for detailed consideration of tariffs proposed by the inset applicant or of other aspects such as reliability of its system. It suggests a less interventionist approach to pricing regulation and licensing.

The Docklands Authority

The Docklands Authority indicated that Powercor was part of a consortium that was awarded a contract, amongst other things, to provide electricity that complied with the *Electricity Industry Act*, relevant standards and any Victorian licence to distribute electricity. Further, its objectives for the development of Docklands included a desire that the cost of being a resident, occupier or visitor to the area should not be greater than other comparable parts of Melbourne. In this context "*the Authority supports market competition for the supply of services, subject to the cost and economies involved e.g. in relation to duplication of services and cross-subsidies*".

GPU PowerNet

GPU PowerNet indicated that it had been approached by Powercor to sublease land at the FBTS site for a new substation to provide the Docklands. It has discussed design aspects with Powercor. It indicated that CitiPower had indicated that it did not consider it appropriate to enter any discussions on sharing arrangements at this stage.

Southern Hydro

Southern Hydro indicated that it had no reason to believe that Powercor "*would not be able to comply with the conditions of providing additional distribution licensing*".

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[80] Institute of Public Affairs, "The ORG's *Discussion Paper* on Powercor's Application for a Variation to their Distribution Licence to include the Docklands area", 30 July 1998.

Hazelwood Power

Hazelwood Power indicated that it had no fundamental objection to Powercor's application.

A.3 Summary of Submissions in Response to the *Pre-Decision Consultation Paper*

Powercor[81]

Powercor's submission argues that the Office should consider inset licence applications for greenfield sites only. In the current regulatory environment it is only greenfield sites that generate economically efficient outcomes. By-pass should not be considered due to the current regulatory distortions, which limit the ability of an incumbent to respond to competitive threats. Powercor defines a greenfield site as:

- a site where there is no significant stranding of assets where assets are defined in terms of their economic value;
- a viable stand alone network, large enough to yield economies of scale and scope is possible; and
- a network which can be easily technically and economically ring-fenced.

Powercor considers that actual competition and/or the threat of competition in the Docklands area will ensure prices and service levels are set in a competitive and efficient way. Powercor expects that such a competitive model will deliver greater long-term benefits to customers in the Docklands area and the potential for Docklands customers to receive tariffs lower than the current CitiPower published tariffs. If Powercor had not sought a licence to operate in the area, Docklands customers would only receive CitiPower tariffs.

Regulated outcomes should only be considered if and only if the competitive market model has been shown to fail because regulation will crowd out competitive market solutions. If the competitive market is shown to fail and a regulated outcome is justified, it should be through specific incentive-based price regulation developed for the Docklands area.

The franchise bidding process proposed by the Office should not be implemented for the following reasons:

- it will cause further delay to the Office releasing a decision on Powercor's licence application and therefore expose Powercor to further unnecessary commercial risk;
- it is inconsistent with a fundamental principle of the ESI regulatory framework and the basis in which the distribution businesses were privatised;
- it presupposes a monopoly franchise when distribution licences are non-exclusive in respect of geographic areas and the Docklands is a competitive model with the strong prospect of multiple licensees;

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81 Powercor, *Powercor's Licence Application to Include the Docklands Area Submission to the Office of the Regulator-General: Response to the Pre-decision Consultation Paper*, 7 May 1999.

- it will not deliver the benefits that a fully competitive model will where multiple licensees are able to compete to supply simultaneously; and
- if the model is applied to sites other than greenfield sites, it may lead to wholesale duplication of existing assets due to the regulatory distortions built into the framework which limit an incumbent's ability to competitively respond.

CitiPower[82]

CitiPower agrees with the Office's basic proposition that distribution networks are largely "natural monopolies" and should be regulated as such. It disagrees that the Docklands market *"is likely to be well above any minimum scale*," or the point where scale economies in power distribution service are exhausted. Two reasons are given in support of this view:

- the demands of the Docklands market have yet to be forecast with confidence; and
- some empirical evidence suggests that CitiPower's entire operations have not exhausted all available scale economies so that the Company as a whole has not yet attained an efficient scale.

CitiPower disagrees with the suggested franchise bidding process. It considered that if it was proposed to re-auction the franchise at its expiration, then a well-known problem with such a process is that the winners of such auctions have relatively weak incentives to maintain their assets since they can lose the franchise in the future. In turn, since improper maintenance may not be immediately reflected in reliability or quality problems, particularly for new distribution facilities, CitiPower suggests that the Office may have to undertake ongoing and detailed evaluations of the behaviour of the franchise winner to insure that deferred maintenance costs are not shifted to future franchise purchasers.

CitiPower considers the Office has failed to understand its new connection policies, procedures and practices of the industry and how the property development industry interacts with the electricity supply industry. It considers that the proposals contained in the Paper would represent a fundamental change to the whole basis of regulation and the way developments are administered and executed.

While agreeing that distribution networks are natural monopolies, CitiPower suggests that the exercise of such a monopoly is subject to significant constraints. The '*supply-takers*' are very capable of exercising countervailing powers to offset the apparent monopoly, particularly larger developers such as Mirvac, Becton, Office of Major Projects, Lend Lease and Central Equity. In addition, it considers that, as for transmission assets, distribution assets can be stranded, particularly around sites of large loads and there have been recent examples, especially within mature distribution networks.

There is the appearance of a 'window of opportunity' for distributor competition with 'greenfields' sites, provided the site is sufficiently large, diversified loads are proposed and the site is accessible to a number of distributors. Notwithstanding the difficulty of encouraging efficient competition even in these ideal circumstances, the

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82 CitiPower, *Response by CitiPower to the Docklands Pre-Decision Consultation Paper*, 7 May 1999.

Docklands, which CitiPower does not regard as a greenfields site, does not meet these criteria, being:

- a long, narrow, but small site, averaging less than 400 meters wide (200m from the central public reserve or main road) with sections less than 100 metres wide;
- existing assets along both the full length and some across the width;
- accessible to only one distributor with water along one side; and
- little or no energy intensive industry, due to land cost and EPA restrictions.

CitiPower also suggests that the introduction of network competition will allow developers to exercise monopsonistic powers against multiple distributors and seek to minimise the developer contributions for new connections in the Docklands. Some developers have informed CitiPower that they have been encouraged to seek "*payments*" from potential distributors, thereby further reinforcing the distortions in efficient pricing generated by the "competition" to distribute. If the precinct developer were to enter into an agreement with a distributor for lower network tariffs, there are serious regulatory issues to be able to effectively transfer these benefits to future occupants, particularly to tenants.

Finally, CitiPower is of the view that franchise bidding is completely incompatible to the existing building block, rate base regulated regime and will impose new and costly burdens on Office and electricity distribution business staff. Even if ring-fencing could be effectively administered, the administrative burden and equity issues raised would place the whole of the regulatory regime in conflict with the objectives of the Government for electricity reform in Victoria.

United Energy[83]

United Energy had two main concerns with the *Pre-Decision Consultation Paper*:

- the franchise bidding process will not deliver the intended benefits to final customers; particularly end-customers who have not been a part of the original tender process to select the distributor, as in the case with Docklands. It believes that the process has the potential to allow developers to have access to those benefits; and
- pricing distortions may not be handled sufficiently well enough.

United submits that the significant impact of uneven regulatory encumbrance on the distribution businesses needs to be addressed adequately in order to facilitate competition. It suggests an approach in the form of a decision framework, which it believes will facilitate the development of competition while ensuring that the intended benefits are delivered to customers.

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83 United Energy, *Docklands Inset Licence - Response to Consultation Paper*, 7 May 1999.

Australian Cogeneration Association[84]

The ACA is concerned that issues surrounding greenfields property development do not artificially constrain proper policy development on contestability for the provision of network services and more specifically the issue of inset networks. The decision on the Docklands application should not unduly impact on other inset developments that may be initiated by end-use customers and embedded generators supplying end-use customers.

The approach that the ACA believes that the Office should adopt is to establish principles and guidelines for the contestability of distribution network services. This involves a number of steps:

- where a network owner (ie licensee) seeks to earn a regulated rate of return on new network investment, a competitive process should be undertaken that provides an opportunity for other options including demand side management and embedded generation to provide the service at lowest cost;
- establish guidelines for the granting of inset network licenses; and
- establish guidelines for licensees where the licensee is not the final consumer of electricity.

The ACA recognises that there are some complex issues associated with inset networks, however it believes that the Office's role should be limited to ensuring that there is fair competition and that where individual customers do not have choice or cannot contract for the service then the Office should regulate the activity. The ACA believes that:

- the Office should maximise the scope for contestability as this drives innovation, flexibility and leads to increased dynamic efficiency;
- consistent with the light-handed regulatory regime in place the Office should rely on market and competitive outcomes as much as possible; and
- the Office's role should be limited to ensuring that there is fair competition and that where individual customers do not have choice or cannot contract for service then ORG should regulate the activity, however this should be as non intrusive as possible and need not be exactly the same as that which applies to existing licensees.

Mirvac[85]

Mirvac had no objection to the Office's attempts to explore and implement opportunities for competition in the provision of electricity distribution services and

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84 Australian Cogeneration Association, *Submission on Docklands Pre-Decision Consultation Paper*, 7 May 1999.

85 Mirvac, *Application by Powercor for a Licence to Distribute Electricity in the Docklands*, 7 May 1999.

urged the Office to make a decision on Powercor's application in order for it to progress on the Yarra Waters Development.

It is Mirvac's intention to seek submissions from electricity suppliers to provide network services. These would be evaluated on cost efficiency, flexibility, security and reliability of supply criteria.

Department of Treasury and Finance[86]

The Department re-iterated its view that the policy framework was designed to encourage contestability in the provision of new distribution infrastructure so that future development may be encouraged. It suggested that the Office develop a set of guidelines that encourages efficient outcomes which removes any artificial barriers to the provision of distribution services on a contestable basis. It is of the view that the developer is the most appropriate person to make a decision on whether to pursue contestability for distribution services and that the framework should ensure that the developer or customer is confronted with a clear choice.

AGL Electricity[87]

AGL does not favour a universal approach. Whether a distributor is selected on the basis of a tender or the incumbent distributor is selected should be dependent on the particular situation and the specific characteristics of the proposed development. AGL notes, however, that a move towards a distributor being selected on the basis of a tender is a move towards location-based pricing. In such a case, the incumbent distributor should also be permitted to base a tender on similar pricing principles for the areas rather than applying a rolled-in price. This will be necessary for the incumbent to compete for new developments in a competitively neutral environment.

A.4 Summary of Submissions in Response to the *Draft Decision*

CitiPower[88]

CitiPower commented that the *Draft Decision* ignores Connell Wagner's conclusions that CitiPower's solution offers a *greater* security of supply. In particular, it commented that Powercor's option does not adequately address the potential for catastrophic risk. In addition, CitiPower commented that 'safety' means limiting the number of cables in the ground and the location recorded in one central data bank, and that more cables mean a greater chance of incidents. It suggested that the Office should refer the matter to the Office of the Chief Electrical Inspector.

CitiPower commented that the potential benefits from competition are small or illusory and unquantified. It noted a number of costs, which include the following:

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86 Department of Treasury and Finance, *Docklands Licence Inset Consultation Paper*, 26 May 1999.

87 AGL, *Application by Powercor for a Licence to Distribute Electricity in the Docklands: Pre-decision Consultation Paper*, 11 May 1999.

88 CitiPower, *CitiPower Response to the Office of the Regulator-General's Draft Decision on the Powercor Application to Distribute Electricity in the Docklands*, 16 July 1999.

- CitiPower will duplicate the system anyway, and so Powercor's costs are additional costs (rather than alternative costs).
- Powercor's operating and maintenance costs will be high (as Powercor will need to install additional facilities in the area) and not a lot of CitiPower's costs will be avoided if it does not supply the Docklands (as its facilities are required for the surrounding areas), and so costs to customers must rise.
- There won't be any incentive to design neighbouring precincts in a coordinated manner, and so that high cost augmentations / interconnections may be required in the future.
- The non-ability to parallel systems in neighbouring precincts will increase cost and/or reduce the security of supply.
- With multiple providers, customers will need to coordinate with several distribution businesses in order to isolate a building to undertake internal maintenance.
- CitiPower also identified a number of additional regulatory costs, which include:
  - that the proposed ring-fencing measures would require intrusive regulation;
  - the fact that the regime will be a one-off implies that the average cost of compliance etc will be large;
  - it will be difficult to forecast the demand in the Docklands as a stand-alone business, and demand in the Docklands will impact on CitiPower's demand (given that some of the new customers in the Docklands may have migrated from the CBD).

CitiPower commented that the *Draft Decision* ignores the fact that the regulatory regime already provides pressure for efficient construction costs and that competition between the distribution businesses is not necessary to achieve this. In particular, there is a licence requirement to seek competitive quotes for major customer-initiated works. CitiPower noted that, unlike Powercor, it does not have an internal construction arm. CitiPower suggested that if the Office considers that the regulatory regime fails to provide the distribution businesses with the incentive to be efficient that the Office is failing in its statutory duty to provide them with the incentive to be efficient.

CitiPower commented that the Office's belief that 'policy wedges' prevent it from pricing efficiently represents a misunderstanding of its connection charging regime.[89] CitiPower also would like to know how the Office intends to treat the TUOS equalisation adjustments. In addition, CitiPower commented that it is normal for the market risk associated with extending supply to new areas to be shared with surrounding areas. It noted that this sharing would not happen if the Docklands were regulated as a stand-alone island system. CitiPower commented that the simple regulatory rule – which would imply that developers would be charged for all of the infrastructure below the trunk level – may impact on the already fragile economics of the Docklands when compared to CitiPower's rule.

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[89] The Office has not stated that it believes that policy wedges necessarily would *prevent* CitiPower from pricing efficiently to new customers. This issue is discussed in section 6.2.3.

Powercor[90]

Powercor disagrees with the Office's conclusion that effective competition is unlikely to exist, in particular, it:

- considers that the threat of by-pass is a real threat;
- notes that CitiPower is likely to install duplicate assets which implies that the barriers imposed by economies of scale and scope are not relevant; and
- comments the Office has not undertaken quantitative studies to assess the level of economies of scale and scope.

Powercor considers that developers have the incentive to negotiate the lowest lifetime cost for electricity without the regulatory rule – and so regulation of prices is unnecessary. In addition, Powercor considers that its commitment that Docklands tariffs be capped at the existing CitiPower rates would ensure that 'Docklands customers capture the competitive benefits … [and] … provide a safety net to ensure no customers are worse off as a result of competition'.

Powercor considers that, in assessing the benefits of competition, the Office is overlooking the benefit provided by Powercor's entry – which is without its entry, Docklands customers would have received the standard CitiPower tariff whereas the entry of Powercor will permit them to have lower prices.

Powercor commented that the effect of the *Draft Decision* is to prescribe how connection charges should be determined for Docklands. Powercor considers that the Office provides distribution licensees with flexibility elsewhere as to how connection charges should be determined.

In relation to other regulatory issues, Powercor:

- seeks information on what prices will apply prior to 1 January 2001;
- wants any ring-fencing obligations applied equally to its competitors;
- notes that the load growth for individual distribution businesses within the Docklands will be uncertain, and seeks information as to how this will be determined. Powercor notes that if CitiPower's tariffs were to be used as a benchmark, then the load growth risk would reside with the distribution licensee; and
- reiterated its opposition to the use of the franchise bidding model for selecting the electricity distribution licensee.

Powercor commented that it would work with the Office over any TUOS equalisation adjustment issues.

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90 Powercor, *Powercor's Licence Application to include the Docklands Area: Response to the Office's Draft Decision*, 16 July 1999.

Dennis Projects[91]

With respect to residential developments, Dennis Projects commented that the standard practice is for the distribution business to approve the design and then for the developer to arrange and pay for the construction. It commented that developers have no way of knowing whether the capital works are gold-plated, so that the best way to eliminate gold plating is to have the distribution business pay for the assets.

Dennis Projects also commented that if a developer pays for assets and factors this cost into the price of developed lots, the net cost to the end-user is greater. Dennis reasoned that when developers pay for assets, you need to add on 'costs such as financing, profit and risk, marketing, advertising and sales commission, legal fees, rates, land tax, stamp duty and GST' which would not enter the equation if the distribution business provided the assets.

EnergyAustralia[92]

EnergyAustralia commented that it fails to see the rationale for regulating the price for the use of the trunk assets once they are duplicated. It noted that if there were concerns about the misuse of monopoly power, then it would be appropriate to cap prices at those charges by the local distributor.

EnergyAustralia commented that if the Office's decision is that the CitiPower option is the least-cost option, then that should be the preferred option. The challenge for the Office is to ensure that the right to provide is allocated on the basis of *economic costs* rather than *average prices.*

EnergyAustralia noted that stimulating competition between *existing* distribution systems only creates pressure for the distribution businesses to allocate more costs to customers in other areas. It commented that any dynamic efficiency arguments only apply where distribution businesses are competing for new markets (and then only if the regulatory framework is efficient).

EnergyAustralia noted that inset networks are likely to result in complex relationships between the local distributor and the inset network. EnergyAustralia's preferred model is for distribution businesses to be required to contract out for new works, but for ownership to remain with the local distributor.

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91 Dennis Projects, *Application by Powercor for a Licence to Distribute Electricity in the Docklands Draft Decision* June 1999, 16 July 1999.

92 EnergyAustralia, *Docklands Draft Decision: Application by Powercor for a Licence to Distribute Electricity in the Docklands*, 29 July 1999.