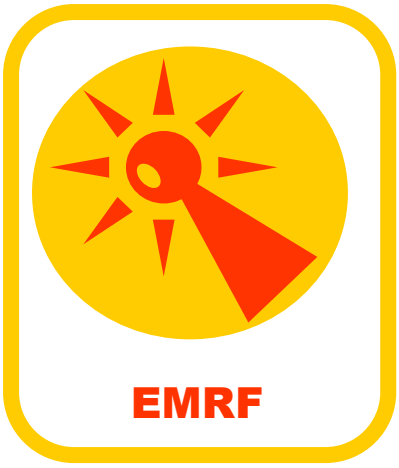

26th March 2004

REGULATORY RISK

IN THE NATIONAL ELECTRICITY MARKET

A real issue for regulated businesses?

A concern for consumers?

A challenge for regulators?

An analysis

by

Headberry Partners P/L and Bob Lim & Co P/L

for

Energy Markets Reform Forum
And
Energy Users Coalition of Victoria

March 2004

Preparation of this report has been partly funded by

The National Electricity Market Advocacy Panel

The support of the Advocacy Panel is gratefully acknowledged by the authors.

Whilst Advocacy Panel funding has assisted the report to be prepared, the content and conclusions reached are entirely the work of the authors.

"[By creating a trust] … Alinta would be able to … put some distance between its capital intensive assets and its high-return service and management business, creating a growth play and a yield play within … a [stable] structure …"

"The [infrastructure] trust [holding the Duke assets] would have significant appeal to institutional shareholders looking for low-volatility long-term results."

"The separation of management and physical assets creates … the happy by-product of quarantining and, to a degree, limiting future regulatory risk."

Excerpts from an article in The Age by financial columnist, Stephen Bartholmeusz, regarding the acquisition of the Duke power and gas assets by Alinta. The article was published on 16 March 2004.

CONTENTS

EXECUTIVE SUMMARY

This report is the first stage in the analysis of how to address regulatory risk. It has been prepared for members of the Energy Market Reform Forum and the Energy Users Coalition of Victoria, to assess whether it is appropriate to further analyse the impact of regulatory risk on regulated businesses and consumers.

The report identifies that there is indeed regulatory risk and this is supported by the quotation from Mr Stephen Bartholomeusz, financial reporter for the The Age newspaper that regulatory risk is an issue which needs to be addressed, that its impact can be "quarantined" and be "limited" in its future effect.

A listing of regulatory risks has been identified and described, although no attempt has been made to assess what is the most appropriate method for dealing with each at this stage.

This report demonstrates that regulatory risk is real and that it impacts on the regulatory revenue that should be allocated to electricity transport businesses.

Individual risks have been identified where the regulator has the responsibility to ensure that the risk is quantified, allocated to one party, and appropriate financial recognition is provided.

This leads on to whether it is in the interests of consumers to pay for these risks, whether the risks are in fact a part of normal business life and therefore included in the build up of the WACC, or whether the risk should be removed and a (downward) adjustment made to the revenue of the regulated business?

If it is seen that there is benefit in further examination of each of the risks identified as being within the class of regulatory risk, then this work must become the focus of the next stage of this report.

1. WHAT IS REGULATORY RISK?

The Competition Policy Reform Act[1] introduced new provisions to the Trade Practices Act (Part IIIA) relating to access to facilities providing essential services. Both competition and pricing problems can arise when it is not economical to duplicate an essential facility. Users wanting the services of the facility may be denied access or be treated in a discriminatory way. This is more likely to be a problem when the facility owner also operates in related upstream or downstream markets in competition with other firms. Since the facility owner will have substantial market power, the other concern is that customers may be charged exploitative prices.

The new access regime, in the first instance, seeks to encourage resolution of access issues by negotiation between the parties. If negotiation fails, a party may seek 'declaration' of a facility. Declarations must obtain the approval and recommendation of the National Competition Council (NCC) and Commonwealth Minister. Declaration then provides a right to negotiate. If a resolution of a dispute is still not forthcoming, the ACCC could be ask to arbitrate the matter.

Under the Act, there are also two other ways access may be handled. First, a facility owner may approach the ACCC with an undertaking that access will be provided on certain terms and conditions. If accepted, this would preclude the possibility of declaration. Second, if a State or Territory puts in place an access scheme which is considered effective in terms of the Competition Principles Agreement, this would replace the Part IIIA declaration and arbitration provisions. This would remove the involvement of the NCC, the Commonwealth Minister and the ACCC.

To enable a degree of consistency of electricity regulation across all jurisdictions, the National Electricity Code (NEC) was developed to provide guidance as to how electricity regulation was to be undertaken. Later in the 1990's a similar code (the National Gas Access Code) was enacted to provide guidance and principles for regulating gas transport businesses.

Regulation is intended to provide competitive pressures on monopoly businesses to minimise the cost of the service contemporaneously with optimising service levels provided. There is a trade off between cost and service level which the regulator must manage. The regulator must ensure that the monopoly businesses receive only just sufficient funds to operate the system, combined with sufficient funds to encourage sensible and needed investment to keep the system viable and growing the suit the needs of the consumers.

In carrying out their regulatory functions the regulators must balance the requests from the asset owners for a level of funding against what revenue would probably be received by the business if it were operating in a competitive environment. It is this balancing of competing interests that introduces the concept of regulatory risk.

From a **service provider** viewpoint, regulatory risk can be basically identified as the regulatory revenue assessment being too low, and that the rules that regulators use now and on which investment decisions are made, can change at some point in the future.

---

[1] This section draws on David Cousins, 'Achieving a Balance Between Competition and Regulation in Growth 44, Implementing the Hilmer Competition Reforms'. Edited by Ian Marsh, November 1996.

Conversely, and tended to be overlooked by all parties involved in the regulatory process, is that consumers also face the same basic regulatory risk – that they will be overcharged for the service provision now, and they will be required to fund into the future, the results of investment decisions made now, but proven by the efflux of time to be quite unsound and unnecessary.

2. THE APPROACH TO ASSESS THE REALITY OF REGULATORY RISK

Initially contact was made by the consultants with a number of regulated businesses providing monopoly services in the transport of electricity in the national electricity market (the NEM). A request was made to the businesses to provide a listing of aspects where the business assessed it was exposed to "regulatory risk". Some possible examples were provided at this time.

The requests were by and large ignored, although there was some feedback provided[2]. Unfortunately significant time was expended in waiting for replies.

This reaction is surprising as a review of applications for revenue caps over the past five years, shows a consistent request (both explicit and implicit) from the regulated businesses for regulators to take into consideration a number of risks said to be faced by the business which were within the purview of the regulator to include or exclude from the review.

To overcome this limited response a review of past applications and regulatory reviews has been undertaken in order to collate a listing of those issues seen as "regulatory risks" faced by the electricity transport businesses.

[2] An interview was eventually held with a network service provider.

3. WHAT IS THE INTER-RELATION BETWEEN RISK AND WACC?

Risk in business is always present. The fact that one entity may take on a risk from another (eg an insurance company) does not cancel the risk, it merely transfers it to another entity.

In business, risks are taken by those normally best able to manage the risk. Thus, if an enterprise elects to accept and mange a risk, then it should be rewarded for doing so. At the other end of the spectrum, if a business lays off this risk to another party, then the party accepting the risk should obtain any benefit arising from managing the risk.

The cost of managing a risk can only be identified if the magnitude and likelihood of an adverse event occurring can be determined. Thus, if the likelihood of a risk can be reduced then the cost can be mitigated.

All businesses face risks which cannot be (or are difficult to be) quantified and the cost of engaging a third party to manage these risks is either excessively expensive or "uninsurable". For a business to enter into an environment where this type of risk is high, then it must earn a high rate of return for those who provide the funding for the business. Such businesses requiring high returns (or a weighted average cost of capital – WACC) to accommodate the high risks they face that the funds invested might be lost, include minerals exploration companies and those investing in research and development. In investment circles such investments are usually classed as "aggressive" or speculative.

Where there is a high certainty of receiving a known revenue, in a well established industry where costs can be reasonably forecast, then the risk is low and the return to investors (the WACC) will be expected to be much lower. Such investments are categorised as "defensive" or "conservative". Investment in electricity transport is classed as a defensive investment as its certainty of revenue and cost structure is well established and revenues are not subject to volatility.

Regulators in Australia use the CAPM formula to set returns for regulated businesses, and in this formula an equity beta (β_e) is applied to adjust for the differing levels of risk appropriate to each business type. The Australian Graduate School of Management (AGSM) publishes values for β_e for different classes of investment calculated from returns obtained by industries operating in the competitive environment.

Thus, as an essential element of assessing whether a regulated business is accepting risks (such as regulatory risk) which would impact unreasonably on the returns investors are getting, there needs to be a compensating adjustment in the WACC to reflect the level of real risks being taken by the regulated businesses.

This then sets the framework for allowing the incorporation of the impact of regulatory risks into the WACC, if indeed such risks are real.

4. WHAT ARE THE ISSUES REFERRED TO AS BEING SUBJECT TO REGULATORY RISK?

Analysis of the various applications for revenue caps, the regulatory decisions and direct inputs by consumers and other stakeholders provides the following summation of regulatory risks.

The various aspects have been grouped into areas where there is a degree of commonality of the issues.

CURRENT ASSET VALUE ISSUES

- **Revaluation of the Regulated Asset Base**.
  At each regulatory review the regulator has the obligation to assess the value of the assets to be used in the calculation of the revenue applicable to the return on assets. The NEC requires that the asset value does not exceed the deprival value. Consistently, regulators have determined to value assets based on the depreciated optimised replacement cost method. This calculation is quite subjective and is based on the perception (usually by an experienced engineering consultant) of what the replacement cost of the assets(using the latest technology) is based in terms of current values discounted by an estimate of the useful life expected for the asset.

  One of the most contentious elements of the calculation is the value assessed for easements, but also regulated businesses have referred to "mistakes" and "omissions" (which have to be corrected) made by the regulator in previous regulatory decisions when the asset value was set

- **Discounting capex spent.**
  A significant element of risk is that a business may undertake refurbishment of an existing part of the network or carryout an upgrade of the network in response to a need. The decision to expend capital for these works may have been initially approved in principle as part of a regulatory review, or part of work assessed by the business as necessary. Either way, the business should be able to demonstrate sufficient proof of the cost/benefit to satisfy the principles embedded in the ACCC's Regulatory Test.

  Notwithstanding that the business may have expended the capital in good faith, believing that it has proven the need and the cost/benefit, the regulator has the power to discount this capex at a subsequent regulatory review if the regulator is not convinced that the expenditure complies with the principles of the Regulatory Test.

SHORT TERM REVENUE VARIATIONS

- **Asymmetric risks**
  Asymmetric risks essentially fall into two categories.

  The first category addresses the issue that after the annual revenue has been fixed by the regulator, the market conditions change, thereby increasing the costs of providing the service. This increases costs but not revenue to balance the costs. Such potential market changes can include sovereign risks such as taxation changes, legislative changes (eg occupational health and safety) and government imposed community service obligations.

The second category addresses the issue that the regulator has the power to truncate the upside potential earnings of the business but require the business to suffer lower than expected earnings if downside potential comes to fruition.

There are two approaches used by regulators to address these asymmetric risks. The first is to permit the business to pass through actual costs incurred (the "no-risk" option) and the second is to increase the WACC to accommodate any increase in risk confronting the regulated business.

If the regulator does not make appropriate provision for any increased risk, then the business is put at risk. Conversely if the regulator over-compensates in assessing the risk, then the business receives a windfall at the expense of consumers.

- **WACC too low to provide funds for needed investments**

A key issue for the business (and for consumers) is that if the WACC awarded is too low, then the business has an inability to secure needed capital to refurbish existing assets and to accommodate for the growth in demand that is a consistent feature for all Australian electricity networks.

If there is a failure of investment due to a low WACC, the regulated business is exposed to the potential of reduced performance (and therefore performance penalties).

Countering this risk is the very real concern that by over-compensating the business with an excessively high WACC, in addition to the transfer of wealth from consumers, there is a driver that the business will be encouraged to unnecessarily augment the network as the returns being gained by the regulated business will prove more attractive to investors than in other areas (i.e. gold plating the assets).

That the regulator sets the WACC for the business does expose the business to the potential of over or under recovery of revenue based on an assessment by the regulator of the risk profile of the business. Such an assessment is relatively subjective.

- **Approach to accommodating tax effects in the WACC**

Different regulators use different approaches to setting the WACC to be used to develop the return on assets. This variation relates to the way the tax effects of imputation are handled.

If a post tax WACC is used based on a given level of imputation then there is a risk to the business that the underlying assumption of the actual tax imputation level for their business is different to the assumption.

If a pre tax WACC is used then there is potential to over or under provide for the business, moving away from the general view that the WACC should have a "vanilla" approach and not encourage or discourage any particular form of business financial structure.

- **Arbitrary reduction of claims for revenue**

As experts in the field of transport of electricity, the regulated business is the best qualified to assess its needs for operating revenue. Equally, the business has an active incentive to claim the maximum operating revenue it can and, if not all of the revenue is used, then this can be taken to profit thereby enhancing returns to the investor.

The approach taken by the regulators is to asses past revenue needs, accommodating for specific additional needs identified and to benchmark the result with the equivalent revenue stream claimed, incurred and/or awarded to similar businesses.

Benchmarking of electricity transport has been carried out largely only by comparison to other Australasian businesses. Each of these has unique features making comparisons somewhat difficult. Despite this regulators have made decisions as to the adequacy of the amounts claimed by regulated businesses, and there have been instances where the claimed amount has been reduced perhaps somewhat arbitrarily by the regulator on advice from its technical consultant.

A reduction in the claimed revenue has the potential to put the business at risk due to it having insufficient funds to provide for the service standards required and so ultimately reduce the overall return the regulated business will gain during the regulatory period.

- **The Regulatory Test**

  The NEC requires the ACCC to develop a Regulatory Test (RT) against which capital investment is to be measured. If the RT demonstrates there is a net public benefit then the investment is accepted. If the proposed investment fails the RT then the proposed work is not permitted into the future asset base.

  The RT as developed has a very high hurdle for proposals to gain acceptance, and as electricity network augmentations require significant investigation to provide the optimum solution there is a very high upfront time and capital investment just to assess the viability of any project. In particular as network augmentations impinge on property held by third parties these costs include for extensive examination of property rights, indigenous aspects and environmental impact issues.

  The RT is currently being reviewed and one of the major concerns raised during the discussions is that the RT may not recognise the full value of benefits the augmentation might provide. An electricity transport network augmentation which is prevented by an unreasonably high hurdle but which may otherwise assist consumers in reducing the power of regional generators (so as to reduce the cost of electricity) is a regulatory risk incurred by consumers.

- **The demand forecast**

  An essential element of setting a revenue cap for a regulated business is to establish the expectation of the changes expected over the regulatory period for the demand for the service. In the case of electricity this is the expected peak demands on each of the network elements and the total volume of energy that is likely to flow over the period. These forecasts influence the amount to be included for capex, the amount of

funding needed for opex, and the final development of the cost allocation to each class of system user.

It is in the interests of the regulated business to maximise the forecast demand for services as this removes the risk that there will be sufficient funds for an unexpected increase in demand. It also provides the business with an opportunity to increase its profitability if the accepted demand forecast is not achieved.

As a result the regulator makes its own assessment of forecast demand growth and then bases the revenue cap decision on its own assessment. This regulatory decision can result in the business being exposed to the risk that the forecast is understated and as a result, being provided with insufficient funds. This is a major issue.

FUTURE ASSET VALUES

- **Bypass and asset stranding risk**

  One of the more common aspects of risk raised by regulated business is the threat of bypass and/or stranding. The regulator ahs a number of options available to it to accommodate the needs of the business, ranging from excising the value of redundant assets from the asset base, though acceptance of rapid partial or full depreciation to allowing retention of the redundant asset in the asset base by rolling forward the previous asset value.

  This issue is further compounded by the issue that an augmentation made now and complying with the RT, may at some time in the future become redundant through changed circumstance, such as the closure of a major consumer. There is no clear signal as to how all regulators will address this dilemma.

- **Technical optimisation**

  The NEC clearly advises that at each regulatory review the asset base of a regulated business is to be optimised. This is implicit in the universally used depreciated optimised replacement cost (DORC) asset valuation approached used by regulators. As has been generally accepted, the DORC asset valuation methodology is a highly subjective valuation technique. This means that regulated businesses are exposed to a subjectively based future assessment of the value of their assets, creating doubt as to the revenue stream in future regulatory reviews, leading to a negative view as to the future investment worth of the business.

  The current review of the Statement of Regulatory Principles implies that this ability to carryout future optimisation may in fact be eliminated by the practice of automatic roll forward of the past asset valuation. That an NEC requirement might well be eliminated by ACCC fiat, in itself imposes a regulatory risk being carried by businesses and consumers.

LONG TERM REVENUE VARIATIONS

- **Uncertainty of future revenue stream after current short term certainty of revenue**

  The bulk of the revenue stream to a regulated electricity transport business relates to its regulated asset value multiplied by the assessed WACC. Typically this one element of the revenue stream will be between one half to two thirds of the total revenue awarded to the business.

  Whilst the revenue stream for the present regulatory period is not known with a high degree of certainty, the business is exposed to the regulator making changes in the asset valuation and the WACC. Regulators do attempt to provide a degree of certainty as to how the regulator in the future *might* approach the setting of core parameters the current regulator cannot bind future regulatory decisions.

ISSUES FOR CONSUMERS

- **Lack of information disclosure**

  A recurring theme in the responses by consumers to applications by regulated businesses for a revenue cap is that the regulated businesses provide insufficient information for consumers to make informed input to the review process. The response from the businesses is usually of two forms – to provide extensive additional information with the anticipation of "flooding" the review process or to claim "commerciality in confidence". Often much of the information provided is not that which is needed for informed comment.

  The regulated business also knows what information it does not want exposed to scrutiny (to do so might disadvantage its arguments for a larger revenue), and by inaction, it has the ability to avoid having to provide information which would otherwise lead to a more balanced regulatory decision.

  The consumer respondent to regulatory reviews is constrained by a number of issues – too little time, too little funds, too little of the "right" information. The flow of information to consumers is effectively controlled by the regulator. If the regulator does not insist that the business provide the appropriate information in a reasonable time, then the consumer is constrained in its ability to provide well developed arguments and access competent expert opinion to counter the arguments put by the applicant.

  This lack of information ultimately leaves the consumer advocate in a position of extreme disadvantage compared to the business which has the funds and the information. This asymmetry of information and funding ultimately requires the regulator to accept some responsibility to assess its own views as to what consumers may consider to be the important issues, placing the regulator, to a degree at least, in the role of consumer advocate as well as being the arbitrator.

- **Regulatory multiplier**

  Regulators have to balance many conflicting views and competing assessments as part of the process of arriving at a final decision as to what constitutes a reasonable

regulated revenue. Many of the inputs can be seen to have a range of appropriate answers and therefore require a subjective assessment in order to set the final single value to used in the revenue calculation.

Of concern is that a consistent refrain in regulatory decisions is that where there is some doubt the decision is made to err in favour of the business. If such analysis applied just once there would be some justification that this is an appropriate response. Unfortunately, a regulatory revenue decision has many such points where there is some doubt, but invariably the regulatory decision is made to favour the business. The "risk biases" in favour of the business have been seen in the award of market risk premium, equity beta, debt premium, elements of opex and capex, and in assessing the regulated asset value.

Where such multiple biases are made in one direction, the final regulated revenue will demonstrate a multiplier effect in favour of increasing the regulated revenue. The continuing adding of a bias in one direction must ultimately result in an over recovery of revenue by the regulated business. This constant addition of "risk biases" has been referred to as the Thenardier Effect after the approach to maximise revenue used by the inn keeper M. Thenardier in the musical show "Les Miserables".

This approach by regulators has resulted in consumers being disadvantaged, with a significant transfer of wealth to the businesses. Regulators should accept that there needs to be a balance between business and consumer when allocating values for specific aspects where there is a range of potential correct inputs.

Regulators should ensure there is a balance between business and consumer interests and where there is doubt, they should not consistently bias in favour of one.

- **Regulatory consistency**

  It is important that regulated businesses and consumers have confidence in the future regulatory approach. If agreement can be reached on appropriate inputs to setting key elements of the various calculations in the revenue setting, then this must be a goal worth pursuing. Further it is important that all regulators accept and use the same settings, eliminating variation between jurisdictions.

  However, this Utopian dream can only come to pass if there is agreement on the settings to be used. There is a major concern that where there is evidence that a setting is proven to be incorrect or of dubious derivation, that regulators examine and adjust the setting to reflect the correct conditions.

  Currently regulators are indicating a preference to use input settings from decisions of other Australian regulators rather than examining new evidence that has been produced which demonstrates that the settings being used elsewhere may be incorrect.

  Regulatory consistency should not be used as an excuse to exclude new evidence from leading to more appropriate changes in the settings.

- **Regulatory circularity**

Regulators use benchmarking to assess the reasonableness or otherwise of applications from regulated businesses for a revenue cap. Particularly, benchmarking is used in assessing the operating expenses to be included in the cap. Consistently the only benchmarking done is that which compares Australian electricity transport businesses amongst themselves.

Each regulated electricity transport business has unique features, with the businesses all claiming these entitle it to a higher revenue allowance. Because the regulators are only comparing amongst the few businesses in Australia (five transmission and ten distribution businesses) the potential for obtaining clear benchmarks for comparison is quite limited. Of greater concern is that with each business claiming unique features, leading to a higher allowance, what is being observed is a general and regular increase in the allowances. With a small population and exceptions made to permit increases, the outcome is an upward spiral over time of benchmark settings against which regulators assess revenue.

- **Regulatory gaming**
  Regulators are consistently faced with the response from a business that if it does not grant what is requested by the business (eg in the way of capex, WACC, opex, etc) then the network will fail and the lights will go out.

  Regulators are aware that if they do constrain the revenue stream of the regulated businesses, the businesses can use this fact when explaining to governments why there has been a system failure.

  Consumers have no such ability to match the market power the businesses have in this regard, and what is being experienced is that when there is doubt, the regulators consistently err in favour of the regulated business.

- **Capex granted for increased demand, but loss of customers does not impact**
  Regulated businesses see that regulators are their "real" customers, in that all negotiations with regard to service standards and revenue are with the regulator.

  As a result there is no penalty on the business if there is a loss of demand due to inappropriate service of excessive cost. At the same time businesses are provided with a return on capital for all expenditure needed for network augmentation.

  The issue of bypass and network stranding as seen as risks to the business, yet there is no pressure on the business to maximise the use of its assets to the benefit of the consumers connected.

- **Revenue allocation between customers**
  Regulators set the revenue cap, and effectively leave the business to establish its approach to cost allocation between consumers. Unless a consumer raises a specific issue the regulator assumes that the cost allocation has been carried out in accordance with the NEC by the business. There are no sanity checks or reviews to identify anomalies.

  This approach has the potential to disadvantage some classes of consumer to the benefit of others. As the business has a revenue cap, it is indifferent to how the cost

allocation returns the revenue and so it is not a direct issue between the business and consumers. The issue is of importance as to whether equity has been ensured between different customer classes. This issue is particularly relevant where the allocation of costs is between consumers and generators.

- **Request for review by a business during the term**
  If there is a changed circumstance which will impact on the profitability of the regulated business, consumers are not permitted to request a mid term review of the revenue cap. Therefore there is potential for the regulated business to enjoy a windfall benefit.

  If there is a changed circumstance which would put the regulated business at risk, the business can request a review of the revenue cap and so seek some relief from the changed circumstance.

ISSUES FOR BOTH BUSINESSES AND CONSUMERS

- **Statement of regulatory principles**
  The current review of the statement of regulatory principles (SRP) provides significant regulatory risk to both consumers and regulated businesses. The very fact that the terms on which businesses and consumers have accepted as providing the rules can be varied provides significant risk to all involved. It is not necessarily the outcomes of the changes that underpin this risk but the fact that the rules under which decisions can be made in the future can be varied.

  Consumers are rightly concerned that the elements of the SRP which provide protection and limit the ability of the regulated businesses to lever an increased revenue for little or no benefit to consumers are at risk of being modified.

  On the other hand the regulated businesses are concerned that the bases on which they have made their investment decisions can be overturned or repealed by the process. Such decisions can result in investments becoming marginal or even loss making.

- **Regulator expertise, experience and lack of corporate memory**
  For regulatory reviews, regulators generally establish teams made up of members who have limited experience in operating in the commercial environment, and even fewer who have a deep understanding of the complex technicalities of AC[3] electricity transport networks. This lack is partially accommodated by the regulatory teams by the employment of technical and other consultants. However the maximise the benefit of these consultants requires the presence on the regulatory teams of appropriate experience to fully appreciate the nuances of the information provided to them.

  Countering the lack of technical expertise by the regulator, the businesses probably have the most technically competent staff in the country to understand the issues of operating an electricity transport business. There can be little expectation that

[3] AC – alternating current.

consultants or the regulator to have similar technical or business competence. This puts both the regulator and consumers at a distinct disadvantage.

Regulators have limited ability to offer personal growth plans to their employees. As a result there has been observed a relatively high turnover of staff involved in regulatory affairs. This reduces the regulatory "memory" of what was included in previous regulatory reviews and of understanding the issues being faced by both the businesses and their customers.

Compounding this, there is a reducing pool of consultants available to contract to regulators who have not been previously employed by the electricity networks.

5. IS THE PERCEPTION MATCHED BY REALITY?

This review of regulatory risk has identified that there are aspects where regulatory risk is real. This then poses the following questions.

Do regulated businesses incur risks from the regulatory environment which are not matched by the competitive sector?

If the risks are real, are they accommodated within the WACC?

Risk is part of life. In the break up of the vertically integrated regional electricity industry, the Australian community developed a code of practice (the NEC) which aimed to allocate the risk to the party best able to manage the risk. However actual operation over the past seven years of this code of practice has shown that there are areas where this goal has not matched actuality. As a result, the key players (businesses and consumers) have identified aspects of risk allocation which need to be further examined.

Regulatory risk is not an issue exclusive to the regulated business. Consumers who ultimately pay for the provision of the electricity transport network also face regulatory risk. Risk can be reduced or eliminated by a range of mechanisms, ranging from paying one party to accept the risk, to legislating on how the risk is to be managed.

The above listing of issues where there is perceived to be regulatory risk covers a wide range. Some of the issues are those faced by businesses operating in a competitive environment and should either be openly discounted by the regulator or openly stated as being included in the WACC.

Equally there is no doubt that regulated businesses do face some unique risks because they are subject to regulatory assessment of their revenue. There are solutions available to many of these issues and changes to the Electricity Code could address some of them.

6. THE NEXT STEPS

This report demonstrates that regulatory risk is real and that it impacts on the revenue that should be allocated to electricity transport businesses.

Individual risks have been identified where the regulator has the responsibility to ensure that the risk is quantified, allocated to one party, and appropriate financial recognition is provided.

This leads to whether it is in the interests of consumers to pay for the assuming of these risks, whether the risks are in fact a part of normal business life and therefore included in the build up of the WACC, or whether the risk should be removed and a (downward) adjustment made to the revenue of the regulated business.

If it is seen that there is benefit in further examination of each of the risks identified as being within the class of regulatory risk, then this work must become the focus of the next stage of this report.