

# Unbundling Australia's Utility Regulation

**B. Stephen Labson**

A USTRALIA'S national competition policy reform, as first outlined in the 1993 Report of the Independent Committee of Inquiry into National Competition Policy (Hilmer et al., 1993), reflects an appreciation of the benefits to the community of extending pro-competitive policies to sectors of the economy that have previously been exempt from them. This approach, further developed and agreed to by the States, Territories and the Commonwealth in the Competition Principles Agreement (CPA) (COAG, 1994) has been a driving force in the structural reform of Australian utilities, which, until recently, have been predominantly state-owned statutory monopolies.

A key component of this reform has been the structural separation of the state's role as shareholder from its responsibility as regulator. Previously, matters of the community interest such as pricing, customer service standards, dispute resolution, environmental impact, and social obligations were addressed primarily by the utility itself (and indirectly through ministerial oversight). Now, they are increasingly being addressed within a rather more independent and transparent regulatory structure applied to both state-owned and privatised utilities.<sup>1</sup>

This new regulatory framework can be seen as an 'unbundling' of the state's authority to regulate utilities in the community interest. It is not, however, to be confused with outright deregulation.<sup>2</sup> Nevertheless, interest groups have voiced concern that these new regulatory structures will not be sufficiently robust to ensure that the broad range of community objectives are met. To address these concerns, a number of adjunct conditions, in the form of corporate objectives or conditions of licence, have been placed on utilities as a means of gaining support for corporatisation and/or privatisation. In the process, broad policy initiatives have often become intertwined with those conditions which are sensibly placed on an enterprise as a requisite of industry participation, such as environmental, health, safety and fair trading regulations. Not surprisingly, many of the benefits associated with regulatory separation have been forgone where rebundling has occurred.

---

<sup>1</sup> For a comprehensive survey of utility restructuring in Australia, see King and Maddock (1996).

<sup>2</sup> Some aspects of New Zealand's system of 'light-handed' regulation comes closer to true deregulation. For a discussion of this approach, see Bollard and Pickford (1995).

*B. Stephen Labson is a Senior Consultant with ACIL Economics and Policy (Sydney).*

### **The Basis for Structural Separation of Utility Regulation**

The structural separation of the state's role as shareholder and regulator is an integral part of the broader agenda of infrastructure reform. A key component of the reform agenda has been to put public and private businesses on an equal footing. This 'competitive neutrality', as described by Councillor Stuart Hohnen (1996:15),

aims to promote a more neutral competitive environment where the private and public sectors are in competition, so that the same rules are applied to all enterprises regardless of their ownership. The principles are implemented by removing any competitive advantages and disadvantages which a government business enjoys over its private sector rivals by virtue of its ownership. Example of such advantages might include immunity from various taxes and charges and access to finance at concessional interest rates, while requirements to provide community service obligations may confer a competitive disadvantage.

The CPA characterises the objective of competitive neutrality as the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities. In addition to the features of operational restructuring, such as corporatisation of government business enterprises and application of tax-equivalent systems and debt guarantee fees, the CPA calls for regulation to be imposed on an equivalent basis to private sector competitors. Where competition is to be introduced into the sector, regulatory functions would be relocated away from the state-owned utilities which previously had primary responsibility for them.

In some circumstances, competition may not be feasible because of natural monopoly aspects of the provision of services. If this is the case, competitive neutrality is irrelevant by definition. However, it is becoming increasingly understood that the empirical basis for judging many components of utilities as natural monopolies is less than robust. Where statutory franchise has been unwound, competition has often flourished within sectors previously thought to be immune from competitive pressures (components of telecommunications and electricity supply provide examples) and also among related markets (competing energy markets, for example). The principles of competitive neutrality may, therefore, be relevant in sectors which have historically been seen as natural monopolies, and reasonable effort should be taken to *allow* for the development of competition whether it currently appears feasible or not. In addition, regulatory separation brings with it intrinsic benefits, particularly in sectors which are not open to competition. The potential for political interference and conflict of interest in the operations of the utility are reduced, and regulation of the industry becomes more transparent and open to public debate.

The Victorian experience of utility reform provides an example of how the community can benefit from the unbundling of regulation (as well as some examples of how the aims of competitive neutrality have become perverted, which is dis-

cussed later). Dieneka Walker (1997) describes the utility-consumer relationship prior to restructuring of the Victorian electricity supply industry as one in which information about prices and the terms and conditions of supply were scattered throughout many regulatory instruments. The State Electricity Corporation of Victoria was both service provider and regulator, with ministerial oversight taking place in a manner which was not particularly amenable to public scrutiny. As a result, information was not accessible, and consumer rights and obligations were poorly defined, difficult to identify and effectively unenforceable. Under the current regulatory structure, the Office of the Regulator-General is responsible for issues arising from the monopoly status of electricity supply to franchise customers. An important aspect of this has been the development of a Supply and Sale Code, which specifies the minimum standards under which a distribution business may supply electricity to a franchise customer. Matters which monopoly service providers are now required to define clearly include the quality, reliability and safety of supply; billing schedules; credit mechanisms; disconnection policies; and dispute resolution procedures. This same basic model of regulating against the abuse of monopoly power is rapidly becoming a standard feature of the regulatory landscape in the era of microeconomic reform. For example, New South Wales has an analogous body (the Independent Pricing and Regulatory Tribunal), and other States have in place, or are developing, similar arrangements for regulating utilities.

### **So What's the Problem?**

With the implementation of the CPA and its consequent prescription for regulatory reform, it is fair to ask what is left to discuss. Unfortunately, in many cases the newly developing structure of utility regulation in Australia retains some of the less beneficial features of the previous regime. A few examples are provided to illustrate some of the drawbacks associated with the rebundling of regulation.

*Corporate objectives.* Consistent with national competition policy reforms, corporatisation of state-owned utilities establishes a framework which separates the utility's role as operator from the state's role as resource manager. However, in some cases, this separation has been impaired by embedding broader public policy objectives in the operational performance of the utility. While such objectives may indeed have the support of the community and be entirely appropriate policies to pursue in themselves, making them an objective of a business enterprise can lead only to confusion of purpose on the part of management, thereby diminishing the utility's performance and value to the community.

Sydney Water provides an example in which operational and social objectives have been rebundled under corporatisation of the state-owned utility. The Water Board (Corporatisation) Act 1994 specifies objectives of the utility related to operational efficiency, environment, and protection of public health. More specifically, Section 22(3) of the Act contains a rather prescriptive set of measures which the Corporation is to have regard for in implementing the principal objectives, including:

- the reduction of environmental impacts and discharges into or on to the air, water or land substances likely to cause harm to the environment;
- minimising its creation of waste by the use of appropriate technology, practices and procedures;
- reducing its use of energy, water and other materials and substances;
- re-using and recovering energy, water and other material and substances, used or discharged by it, by the use of appropriate technology, practices and procedures;
- reducing significantly, by 30 June 2000, the combined environmental impact of the per capita amount of energy and water used by the Corporation and other materials and substances discharged by the Corporation, compared with that impact in the year ending 30 June 1994.

Whatever the merit or feasibility of these particular objectives, it is clear that they provide a poor basis on which Sydney Water could be expected to maximise its performance and value to the community as customer or shareholder. It no doubt seems pedestrian to suggest that matters of public policy be addressed by those institutions normally charged with such responsibilities; but this obvious solution has been forgone in this case. More to the point, these types of broad community objectives could be much more efficiently dealt with by a whole-of-government initiative, and probably miss their mark when allocated to one particular enterprise. This is not to suggest that the enterprise should be exempt from standard conditions of industry participation, such as compliance with environmental licence conditions, public health, occupational safety and so on. It does draw the line, however, at moving beyond what the community *generally* expects from the commercial operation of an enterprise.<sup>3</sup>

*Conditions of licence.* A rather new feature of the regulatory landscape facing utilities has been the development of industry licence arrangements. Whereas utilities previously operated under statutory authority, they now are required to comply with explicit conditions of licence. The provision of these conditions, particularly where customer choice is absent, has been seen as a means by which to protect the consumer, monitor and maintain the integrity of the system and ensure that markets operate fairly.

In restructuring its electricity supply industry, New South Wales has taken a broader view of the role of operational licensing. Under the Electricity Supply Act

---

<sup>3</sup> The CPA is rather ambivalent to this matter, in that it prescribes that government business enterprises are to be subject to the same set of regulations as the private sector (s.3(4)(b)(iii)), but does not require jurisdictions to remove regulations from the enterprise which it deems as 'appropriate' (s.4(7)).

1995, environmental conditions have been embedded in the operating licence of retail electricity suppliers, requiring them to develop strategies for reducing greenhouse gas emissions stemming from the generation of power supplied to their customers. But the problem of greenhouse gas emissions is not unique to the electricity supply industry, and, as such, is not well addressed within the narrow confines of a state-based retail licence arrangement. Strategies based on a broader array of policy instruments are likely to provide a more efficient means for meeting community objectives. As well, where different approaches to greenhouse gas reductions are implemented on an *ad hoc* basis across related or interconnected industries, they have the potential to distort competitive market signals, leading to poor outcomes in terms of allocative and productive efficiency.

An equally important issue arises with respect to the transparency of public policy. The costs of emission reduction programs brought about by licence conditions will be embedded, most probably invisibly, in customers' electricity bills, making it difficult for the community to determine whether it is getting value for money out of these measures. Where broad community objectives are addressed within the rather narrow scope of utility regulation, issues of public policy can become hidden within the arcane structure of that utility, affording little scope for open public debate.

*Concessionary pricing policies.* For a variety of reasons, utilities have served as a means of transferring income between groups through the provision of uniform tariff structures. Of course, the redistribution of income as mandated by the general public is entirely consistent with the principles of competition policy. However, as James Cox (1996) points out, the redistribution of income *through pricing policies* can be inefficient, as the distribution of benefits are not often well targeted. In addition, where pricing policies are based on cross-subsidy (as opposed to direct budget funding of concessions), transparency in the development of social policy is diminished, potentially leading to programs whose purpose is unclear or inconsistent with the objectives of the community. Within the context of structural reform of utilities, the process of corporatisation has forced State governments to reconsider their approach to uniform tariffs. For the most part, the poorly targeted and opaque pricing policies of the past have been retained.

A clear example may be found (perhaps ironically) in the Victorian electricity supply industry,<sup>4</sup> where a uniform tariff policy to residential customers has been embedded within its Tariff Order (Governor in Council, 1995) and proposed derogations to the National Electricity Code of Conduct (NGMC, 1996). Under this system, transmission and distribution charges (which are a significant proportion of total charges facing the consumer) have been artificially adjusted, such that rural prices will be held at roughly the same level as those in metropolitan areas. While

---

<sup>4</sup> Victoria is by no means alone in perpetuating the non-transparent delivery of uniform tariffs. It does, however, provide an interesting example of public policy objectives being rebundled with operational aspects of the market within a newly privatised system.

the mechanism for perpetuating the uniform tariff is rather complex, the matter is essentially closed to public debate. This is unfortunate, since uniform tariffs would appear to be precisely the kind of pricing policy that Cox (1996) has shown to be an inefficient means of redistributing income. Uniform tariffs redistribute income on the basis of geography, which has little relation to the dispersion of wealth across the broad community. Where prices do not reflect costs, they distort electricity consumption choices and so undermine allocative efficiency. And productive efficiency is lessened where access to the network distorts technology choices: for example, remote area power generation (either fossil-fuel based or renewable) might be a cost-effective alternative to grid power, but forgone due to pricing distortions.

### **Concluding Remarks**

Competition policy has taken an important step forward in guiding the restructuring of utilities across Australia. The structural separation of the state's roles as shareholder and regulator has facilitated competition in sectors previously immune from competitive pressures. This new competitive environment will provide the impetus for better operational performance by state-owned utilities, providing benefits to the public both as customers and as shareholder.

Issues pertaining to the operation of an industry should remain separated from the community's broader policy objectives, regardless of how laudable those objectives may be. Several considerations support this position. First, narrowly based industry mechanisms, such as pricing policies, licence conditions or corporate objectives, provide a poor basis for implementing broad policy measures, in that constraints will be placed across related sectors in a non-uniform manner. Where this is the case, competitive neutrality across these sectors is reduced, leading to a diminution of the benefits flowing from allocative efficiency.

As well, the productive efficiency of the utility can be diminished where the objectives of corporate activity are confused with regulatory constraints. For example, management is provided with a clear focus when shareholders demand that a corporation maximise returns, subject to its acting in a responsible manner by meeting general conditions of industry participation. It is far less clear what is expected when that corporation is required to maximise a set of social objectives as well. The ambiguity of this situation can easily lead management taking decisions which are deficient in both areas.

A final consideration is related to the transparency and effectiveness of public policy. Industry-specific instruments such as operational licences can provide an effective means by which to regulate aspects of an industry *unique to itself*. Matters more generic in nature, such as environmental protection, public health, and occupational safety are better dealt with in a whole-of-government context, which allows competing interests to enter into the debate and which is more amenable to public scrutiny. This demarcation in regulatory roles also offers a more effective means of addressing the community interest in that it provides a portfolio of public policy instruments. Simply put, addressing broad issues of community concern within the confines of utility regulation would seem to be a case of the tail wagging the dog.

Utilities — indeed, all business enterprises — should function within a commercial environment that is neither sheltered nor hindered by discriminatory regulations. This precept is not nearly as bold as *laissez faire*, or even measured deregulation. It is simply a rule to enhance productive and allocative efficiency in industries where it is accepted that broader community interests should be addressed within a regulatory framework. This position is neither novel nor controversial — nor is it often adhered to in practice.

## References

- Bollard, A. & M. Pickford (1995), 'New Zealand's "Light-Handed" Approach to Utility Regulation', *Agenda* 2(4): 411-22.
- Council of Australian Governments (COAG) (1994), *Competition Principles Agreement*, Canberra (February).
- Cox, J. (1996), 'Redistributing Income through Pricing Policies', *Agenda* 3(1): 31-44.
- Governor in Council (1995), 'Victorian Electricity Supply Industry Tariff Order', *Victorian Government Gazette* No. P4 (30 June).
- Hilmer, F., M. Rayner & G. Taperell (1993), *National Competition Policy: Report by the Independent Committee of Inquiry*, AGPS, Canberra.
- Hohnen, S. (1996), 'National Competition Policy', paper presented at the Competition Policy Conference 1996, Perth (25 July).
- King, S. & R. Maddock (1996), *Unlocking the Infrastructure: The Reform of Public Utilities in Australia*, Allen & Unwin, Sydney.
- National Grid Management Council (NGMC) (1996), *National Electricity Code*, Melbourne (October).
- Walker, D. (1997), 'The New Utility-Consumer Relationship', paper presented at the IIR Conference on Corporatisation, Privatisation and the Convergence of Utilities, Sydney (19-20 February).