



ICRC
INDEPENDENT COMPETITION AND REGULATORY COMMISSION

Information Paper

**Investigation into prices for electricity
and water services in the ACT**

DECEMBER 2002



**INDEPENDENT COMPETITION AND REGULATORY
COMMISSION**

INFORMATION PAPER

**INVESTIGATION INTO PRICES FOR ELECTRICITY AND
WATER SERVICES IN THE AUSTRALIAN CAPITAL
TERRITORY**

DECEMBER 2002

The Independent Competition and Regulatory Commission (ICRC) is established by the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act) to determine prices for regulated industries, advise government about industry matters, advise on access to infrastructure and determine access disputes. The Commission also has responsibilities under the Act for the determination of competitive neutrality complaints and providing advice about other government regulated activities.

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For further information on this inquiry or any other matters of concern to the Commission please contact Ian Primrose, Chief Executive Officer on 62050779.

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1 INTRODUCTION

The Independent Competition and Regulatory Commission (the Commission) is conducting an investigation into prices for electricity distribution and water services provided by ActewAGL within the Australian Capital Territory (ACT). These include the provision of electricity, water and wastewater services to residential and non-residential customers. The investigation will allow price directions/determinations to be issued for each of these services covering the period from 1 July 2004 to 30 June 2009.

Consistent with requirements under the *Independent Competition and Regulatory Commission Act (1997)* (the ICRC Act) the investigation into water and wastewater services will be undertaken based on a reference issued by the ACT Treasurer. That reference will specify specific issues which the Commission will be required to investigate.

Electricity distribution and retail services are separate functions. The ACT Government has recently decided to implement full retail contestability for electricity services in the ACT by 1 March 2003. The Treasurer has issued the Commission with a reference to investigate retail electricity prices for a transitional period of three years. However, the retail price will be a treated as separate matter to the electricity distribution investigation.

Matters to be considered

For electricity distribution, the Commission is required to regulate the prices charged by ActewAGL under the National Electricity Code (NEC). The Commission must have regard to the principles and objectives set out in Part D of the NEC. These can be summarised as:

- to enhance competition, particularly by encouraging new entrants;
- to prevent monopoly rents in an industry and market characterised by a high degree of market concentration;
- to ensure the fairness, transparency of the scheme and accountability of the regulator;
- to ensure that investment is made and used efficiently, including existing infrastructure; and
- to ensure that industry participants are able to achieve “reasonable” returns upon their investment, assuming efficiencies in relation to operation, investment and maintenance.¹

The NEC requires the Commission to determine which distribution services are prescribed distribution services (and therefore subject to economic regulation in accordance with clauses 6.10.3 and 6.10.5 of the NEC) (clause 6.10.4). Those distribution services that are not prescribed are deemed to be excluded distribution services, to which it is appropriate to apply a more light-handed regulatory approach than that set out in 6.10.5 of the NEC.

In making its price directions for water and wastewater services, the Commission is guided by the ICRC Act. In this regard, Part 4 of the ICRC Act requires that the Commission consider various matters in making its pricing decisions. Part 4 is set out in full in Appendix 1, however the matters can be grouped as follows:

¹ Clause 6.10.3(e) is set out in full in appendix 1

Consumer Protection

- protecting consumers from abuses of monopoly power
- standards of quality, reliability and safety of the services concerned
- social impact of decisions
- effect on inflation.

Economic efficiency

- greater efficiency in the supply of services
- cost of providing the services
- effect of functions being carried out by another service provider.

Financial viability

- rate of return on assets including dividend requirements
- impact on pricing of borrowing, capital and dividend requirements of agencies.

Environmental

- promotion of ecologically sustainable development via appropriate pricing policies
- considerations of demand management and least cost planning.

This information paper provides an overview of the proposed investigation process, detailing the approach which the Commission intends to take and key issues for the investigation. The paper also provides an overview of the energy and water industry in the ACT and details the regulatory environment.

Further details of specific issues will be provided within the Issues Paper scheduled for release in June 2003 as part of the investigation process. The June Issues Paper will provide interested stakeholders with an opportunity to respond to the detailed issues raised.

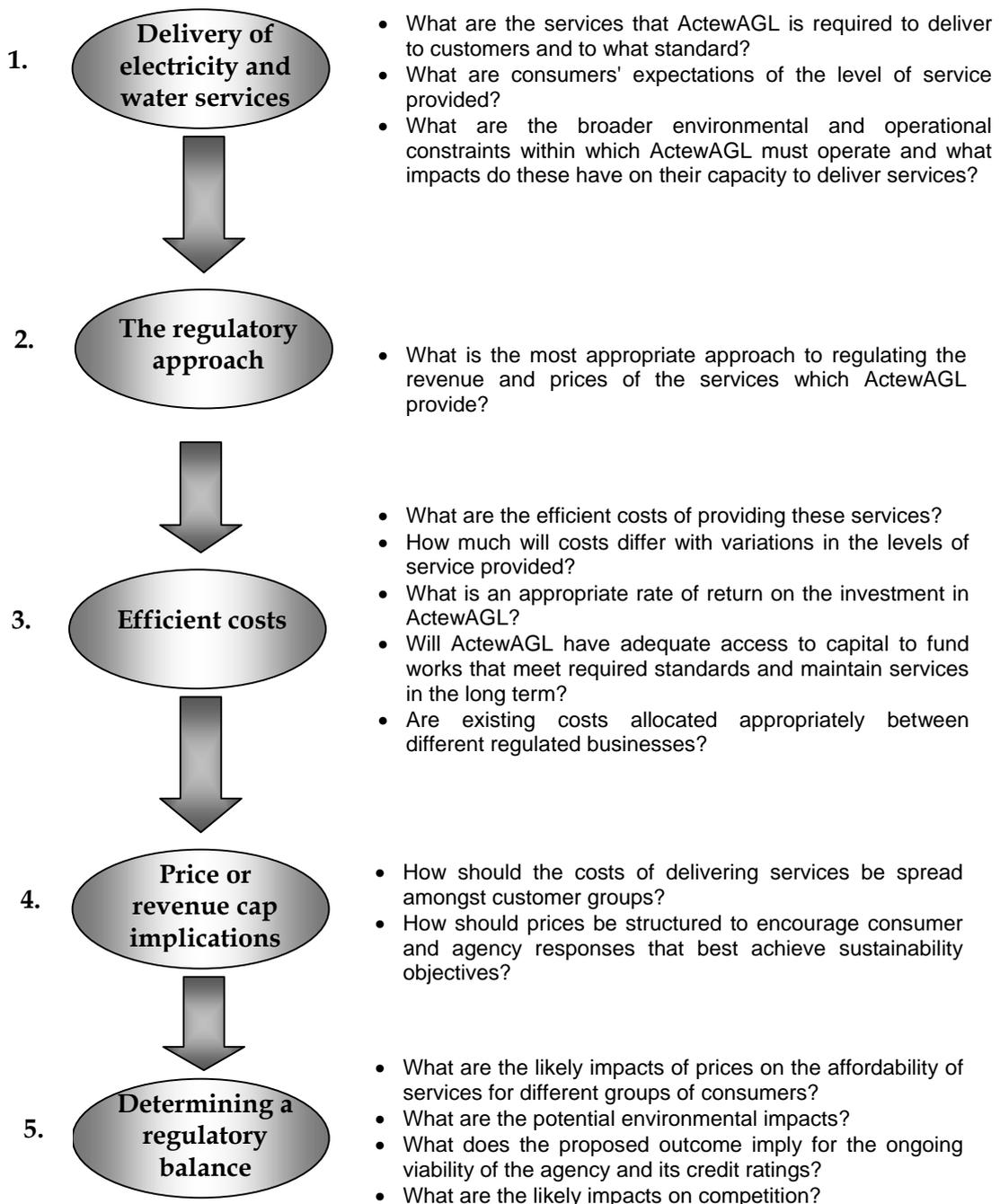
2 THE INVESTIGATION PROCESS

2.1 The Commission’s investigation process

The Commission is committed to an open and transparent investigation process which considers all of the factors required under the ICRC Act and is consistent with the NEC.

The Commission’s decision making process is summarised in Figure 2.1 below.

Figure 2.1: Commission’s investigation process



To assist and facilitate the decision making process outlined in Figure 2.1, the Commission intends to:

- Collect appropriate information to allow a detailed investigation of operating expenditure, capital expenditure, demand assumptions, cost allocation and customer impacts for the investigation;
- Review the prudence and efficiency of capital and operating expenditures by ActewAGL during the price path period to 2004;
- Review the appropriateness of proposed capital and operating expenditures, drivers for these expenditures and estimated efficiency gains for the period 2004 to 2009;
- Receive written submissions detailing initial pricing proposals from ActewAGL and general submissions from other interested stakeholders together with formal discussion of these submissions.
- Prepare and release draft and final reports and price directions/determination.

The Commission has engaged the Secretariat of the Independent Pricing and Regulatory Tribunal of NSW (IPART) to provide specialist consultation assistance in the conduct of the investigation for the electricity, water and wastewater services. The Commission will be engaging other consultants to provide assistance for the gas access arrangement and price review. While IPART staff and other consultants will provide the Commission with some expert advice and analysis, the final decisions and price directions/determination will be those of the Commission alone.

2.2 Regulatory framework

Regulation in water, wastewater and electricity businesses is used in the absence of competition to provide incentives for the efficient delivery of these services, while ensuring other social and environmental objectives are achieved. As ActewAGL is currently the monopoly provider of these services in the ACT, without regulation, there are limited incentives for the business to operate efficiently and improve customer services.

Under the NEC, if the Commission intends to amend the form of regulation for the electricity distribution network, it must specify the new form of regulation² two years in advance of the new regulatory period.³ The Commission has decided to retain the current form of regulation, a revenue cap, for the next regulatory period. This will be based on the maximum average revenue per kilowatt of electricity sales. The Commission gave notice to ActewAGL on 21 June 2002 that it had decided to retain the current form of regulation.

For water and wastewater services, the Commission proposes to retain the current form of regulation, a revenue cap, where the maximum average revenue per property is determined and forms part of the Price Direction (or relevant legislation).

The revenue caps would be adjusted over the price direction/determination period using the CPI±X methodology which accounts for rises in general level of prices, expected efficiency

² In accordance with a form of regulation outlined in *National Electricity Code*, clause 6.10.5.

³ *National Electricity Code* clause 6.10.3 (d).

gains by the business and other significant factors which impact on the operation of the business.

The total revenue requirement for each of the services provided by ActewAGL are determined by the Commission by applying the building block approach as outlined by the Council of Australian Governments⁴ (COAG). The building blocks can be categorised as:

- Operations, maintenance and administration;
- Provision for the cost of asset consumption (eg depreciation);
- Provision for the cost of capital; and
- Externalities.

While assessing the efficient costs relating to each of these building blocks is a fundamental part of the investigation process, the requirement for the Commission to consider matters contained in Part 4 of the ICRC Act or Part D, Chapter 6 of the NEC where applicable, requires the Commission to exercise regulatory judgement in the final decision making process.

2.3 Investigation timetable

The proposed timetable for the investigation as it relates to electricity, water and wastewater services is:

| Task | Timetable |
|---|-----------------------|
| Phase 1 | |
| • Release of information paper | December 2002 |
| • Provision of information request to ActewAGL | December 2002 |
| Phase 2 | |
| • Information returns due from ActewAGL | March 2003 |
| • Review of actual capital and operating expenditure for period 1999 to 2004 | May 2003 |
| • Proposed pricing submission from ActewAGL due | May 2003 |
| Phase 3 | |
| • Release of Commission issues paper | June 2003 |
| • Public and other stakeholder submissions due | August 2003 |
| • Public hearings held | August/September 2003 |
| • Submission of updated information returns from ActewAGL | September 2003 |
| Phase 4 | |
| • Release of draft report and price direction/determination | November 2003 |
| • Stakeholder submissions on draft report and price direction/determination due | December 2003 |
| • Additional public hearings (if necessary) | February 2004 |
| • Release of final reports and price | March 2004 |

⁴ COAG, *Compendium of National Competition Policy Agreements*, Second Edition, 1998, p 112.

direction/determination

- Appeal period for water and wastewater services

April – June 2004

2.4 Participation and registration of interest

The Commission is keen to have the widest possible involvement of stakeholders in the investigation process. It will have an open and transparent consultation process throughout the investigation. The Commission will seek the input of all interested parties through:

- The release of this information paper
- The release of an issues paper
- Invitations to submit comments
- Meetings and consultations to explain and discuss issues
- Public hearings to provide interested parties with opportunities to present arguments to the Commission members.

All interested persons are invited to register their or their organisation's interest in participating in the investigation. The Commission will contact all interested parties as papers are released, meetings and consultation sessions are organised and public hearings are scheduled.

Registrations of interest should be addressed to:

Investigation of prices for energy and water services in the ACT

Independent Competition and Regulatory Commission

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Facsimilie: (02) 6207 5887

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This Information Paper and subsequent issues paper and submissions will be placed on the Commission's website (www.icrc.act.gov.au).

3 OVERVIEW OF THE REGULATED INDUSTRIES AND REGULATORY ENVIRONMENT IN THE AUSTRALIAN CAPITAL TERRITORY

3.1 The provision of energy and water services

The ACT's energy and water, retail and network services are provided by ActewAGL – a joint venture company owned by ACTEW Corporation (ACTEW) and the Australian Gas Light Company (AGL). The joint venture was established since the last price direction in 1999, on 3 October 2000.

ActewAGL operates through a business structure involving a number of interconnected corporate entities⁵. For instance, ACTEW owns the water and wastewater infrastructure but contracts ActewAGL to provide all of the operations and maintenance on the system to delivery water and wastewater services to customers.

In addition to the integration of water, wastewater, electricity and natural gas services within the one joint venture company, each of these services operate within differing industry structures.

Figure 3.1 provides a simplistic representation of the electricity industry's structure including the financial interrelationships and regulatory roles.

Electricity generation occurs within the framework of the National Electricity Market (NEM), which is overseen by the National Energy Market Management Company (NEMMCO). Electricity retail businesses like ActewAGL place bids within the market to purchase certain quantities of electricity within certain time frames. The resolved market price is what the retail businesses pay and electricity generators earn to supply electricity⁶.

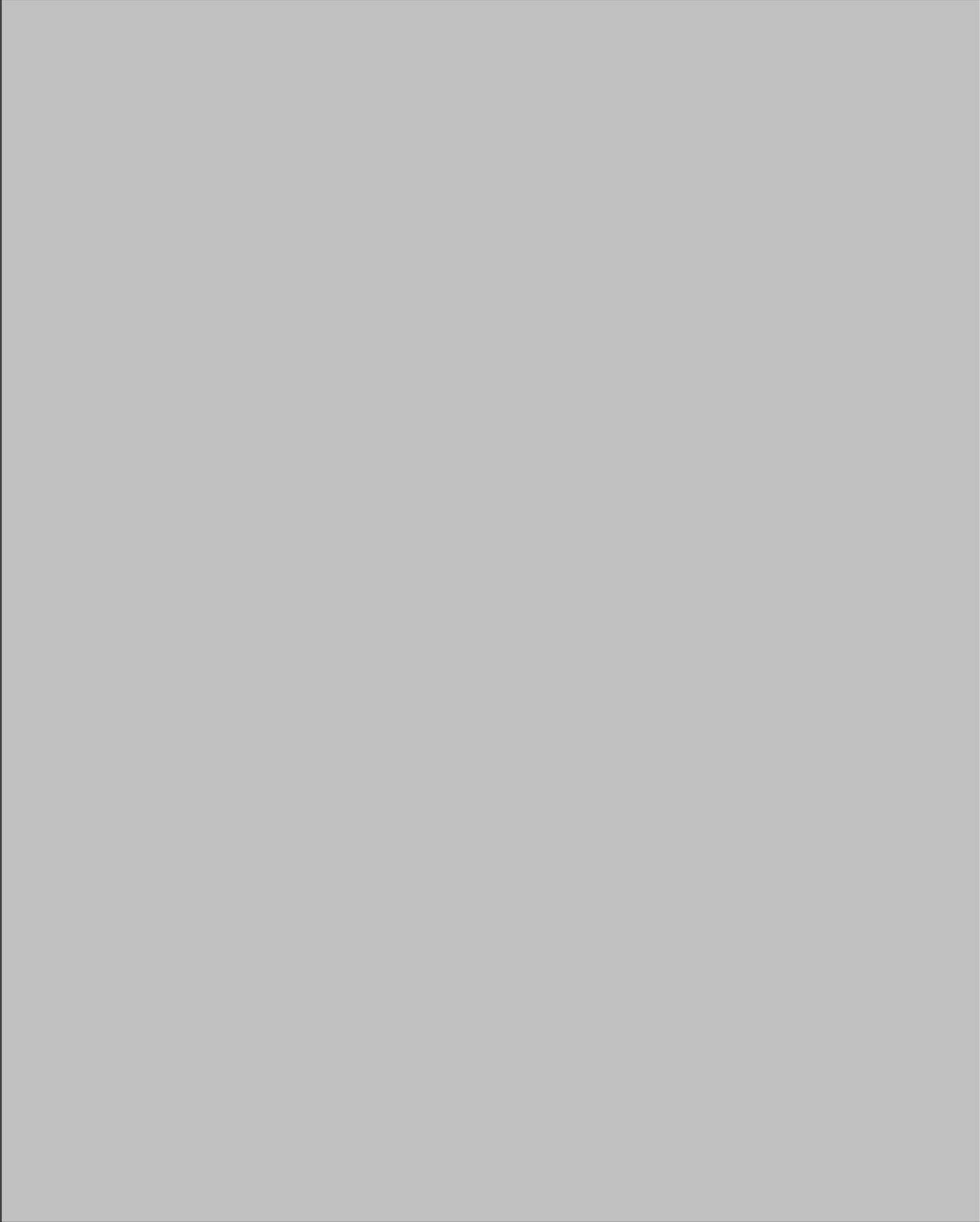
Electricity is transmitted from generators to customers through two separate stages. The first is via the high voltage transmission lines. The New South Wales TNSP, Transgrid, provides these services to ActewAGL. These high voltage transmission networks are considered to be natural monopolies and the prices they can charge for their services are regulated by the Australian Competition and Consumer Commission (ACCC).

The next stage of transmission involves the electricity distribution service, where the electricity from the high voltage lines is transferred to the distribution network for delivery to individual customers. It is this distribution service which ActewAGL provides in the ACT and for which the Commission is undertaking its price review. Distribution services are regulated by the NEC which is applied by the Commission when conducting its investigation.

⁵ See Appendix 2 for a diagrammatical representation of the joint venture arrangements.

⁶ Retail businesses are able to contract specifically with generators to minimise price risks along with the use of a variety of financial instruments. For further details of the operation of the national electricity market visit www.nemmco.com.au

Figure 3.1 Representation of electricity supply in the ACT



Customers purchase electricity from retail businesses which in the ACT is currently also the network distribution service provider – ActewAGL. The ACT Government has decided to deregulate the retail electricity sector allowing competition for the sale of electricity to customers commencing 1 March 2003. This process is known as full retail contestability (FRC) and when fully implemented would mean that retail electricity prices will no longer be set by the Commission.

Figure 3.2 provides a diagrammatical representation of the water and wastewater industry in the ACT.

ActewAGL operates and maintains the water and wastewater infrastructure to deliver these services to customers in the ACT. This is conducted under a contractual arrangement with ACTEW Corporation which has maintained ownership of the water and wastewater infrastructure. The Commission is the price regulator for water and wastewater services in the ACT.

ActewAGL's business services in excess of 125 000 customers for water and wastewater services, 135 000 electricity customers and 85 000 gas customers. It operates almost 6 000 kilometres of water and sewerage mains, delivering over 60 gigalitres of water every year. ActewAGL has over 900 employees servicing an estimated 320 000 people living in the ACT.

Appendix 2 provides a detailed representation of the relationships between ACTEW and ActewAGL for the provision of energy and water services in the ACT.

3.2 The regulatory environment

While this Information Paper addresses electricity distribution and water services only, the Commission considers it useful to place the review in the broader regulatory context. In addition to the requirements of the ICRC Act, there are a range of other regulatory instruments which impact upon the provision of energy and water services in the ACT. These include:

- Utilities Act (2000)
- Industry codes including network boundary codes
- Technical codes including supply standards and operational safety requirements
- Utility Networks (Public Safety) Regulations
- Requirements under the NEC
- Requirements under the National Third Party Access Code for Natural Gas Pipeline Systems

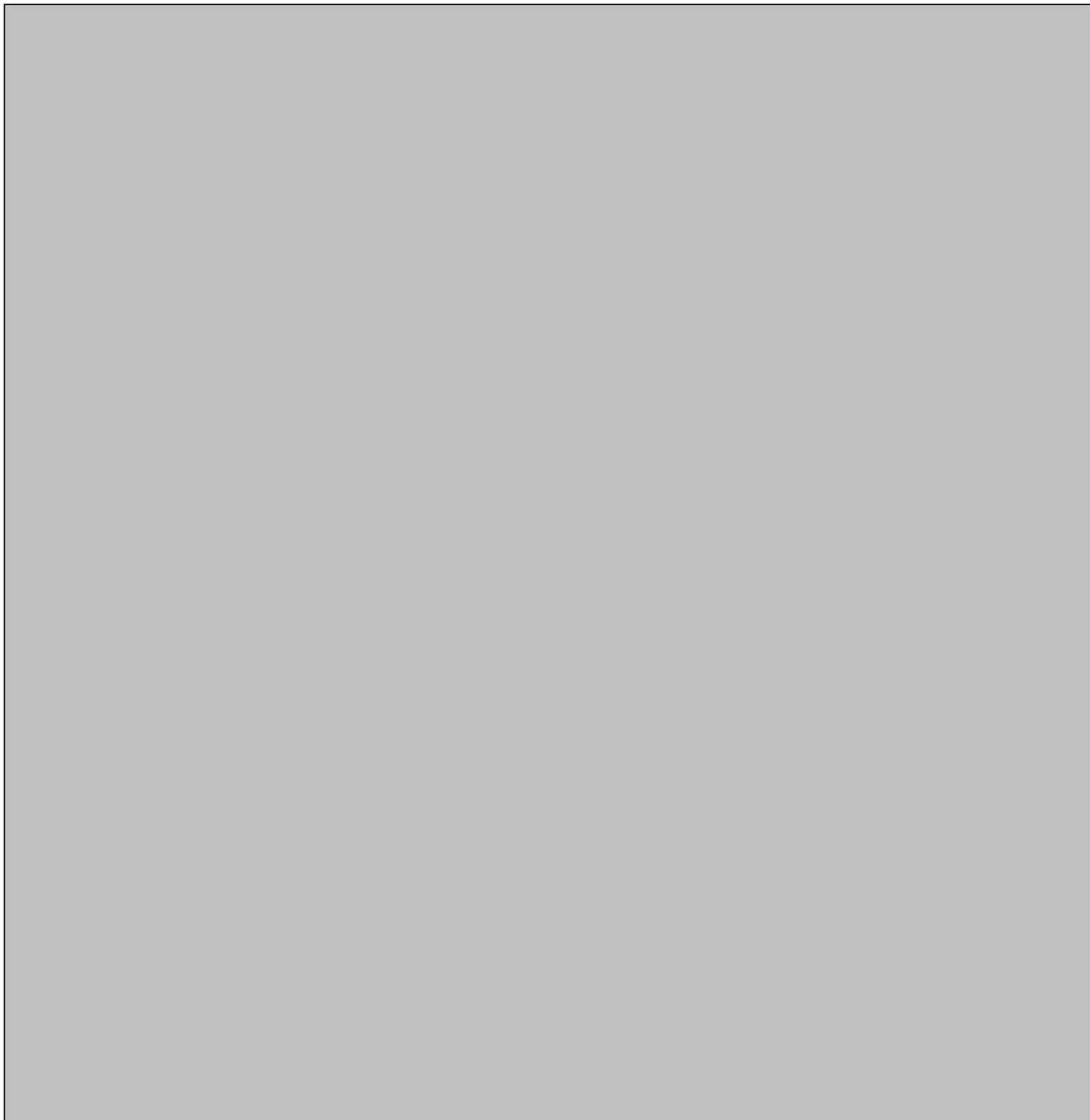
Some further detail on these additional regulatory instruments is provided in Appendix 1.

All of these instruments will be taken into consideration by the Commission when considering the efficient costs of ActewAGL for the provision of energy and water services.

3.3 Full retail contestability

Consistent with the COAG competition reforms previously mentioned, the ACT Government has adopted a policy of promoting full retail contestability for the provision of gas and electricity services in the ACT.

Figure 3.2 Representation of water and wastewater service supply in the ACT



The ACT Government has announced that full retail contestability will be implemented for electricity effective from 1 March 2003. There will be a transitional period of up to three years, during which time the Commission will continue to regulate standard customer contracts. The review of these contracts will be held separately to the investigations relating to water and electricity distribution. While the market will be contestable the government has agreed to provide a transitional arrangement for all former franchise customers for a period of up to three years. The transitional arrangements will mean that customers using less than 100MWh pa will remain on a standard customer contract under the Utilities Act and subject to a tariff to be determined by the Commission. Customers may remain franchise until they decide to enter a negotiated contract, that is accept a product offering from a participant in the contestable market.

3.4 Other regulated services

The total system for energy services involves more than the electricity and natural gas distribution networks and retail services that exist within the ACT's border or jurisdictional responsibility. While natural gas issues are not covered in this information paper, it is expected that the Commission will release a further paper discussing issues arising out of any amendments to the gas access arrangements in the ACT.

The generation of electricity occurs outside the ACT with retail suppliers entering into contract arrangements with generators to meet customer demand for energy. As Figure 3.1 illustrates, this occurs in an open market environment. Purchased electricity is transmitted via high voltage line to the ACT and is converted to the distribution network supporting the ACT market. Access to and the use of the transmission network is regulated by the ACCC with costs 'passed through' to the distribution network and retail services.

The supply of natural gas is also sourced outside the ACT with current supplies in the Cooper Basin, South Australia (Moomba) and Bass Strait (Longford) being purchased by retail suppliers and transported to the ACT to meet customer demand. Natural gas is transported via two inter-connected transmission pipelines that are connected to the ACT, Queanbeyan and Yarrowlumla distribution network. Lateral pipelines connect the transmission pipelines to the local distribution network (at North Watson and Hoskintown).

The Moomba to Sydney pipeline and lateral, which is owned and operated by the East Australian Pipeline Limited (EAPL), is a regulated transmission pipeline and access to and use of this pipeline is regulated by the ACCC. Similar to regulated electricity transmission costs, these costs are passed through to the distribution network and retail services. The Longford to Sydney pipeline is owned and operated by Duke Energy and is not a regulated transmission pipeline. However, the negotiated contract costs between the pipeline owner and the retail supplier are also passed through to the distribution network and retail services. The lateral pipeline from the Longford to Sydney pipeline is owned and operated by ActewAGL.

Pursuant to the National Gas Code, the Commission also has regulatory responsibility for that part of the natural gas distribution network extending into Queanbeyan and the Yarrowlumla Shire.

APPENDIX 1 IMPORTANT LEGISLATIVE AND CODE SECTIONS RELEVANT TO THE INVESTIGATION

A1 Matters to have regard to

In making determinations the Commission is required by section 20(2) of the ICRC Act to have regard to the following matters:

- i. the protection of consumers from abuses of monopoly power in terms of prices, pricing policies (including policies relating to the level or structure of prices for services) and standard of regulated services;
- ii. standards of quality, reliability and safety of the regulated services;
- iii. the need for greater efficiency in the provision of regulated services to reduce costs to consumers and taxpayers;
- iv. an appropriate rate of return on any investment in the regulated industry;
- v. the cost of providing the regulated services;
- vi. the principles of ecologically sustainable development as mentioned in the ICRC Act (see section 20(4));
- vii. the social impacts of the decision;
- viii. considerations of demand management and least cost planning;
- ix. the borrowing, capital and cash flow requirements of companies providing regulated services and the need to renew or increase relevant assets in the regulated industry;
- x. the effect on general price inflation over the medium term; and
- xi. any arrangements that a company providing regulated services has entered into for the exercise of its functions by some other service provider.

A2 Utilities Act (2000)

The Utilities Act came into force in 2000 prior to the establishment of the ActewAGL joint venture. The Act states that utility services covers the distribution, connection and retail supply for electricity, natural gas and water and wastewater services. The objects of the ICRC in respect of these utility services include:

- i. to encourage the provision of safe, reliable, efficient, and high quality utility services at reasonable prices;
- ii. to minimise the potential for misuse of monopoly power in the provision of utility services;
- iii. to promote competition in the provision of utility services;
- iv. to encourage long-term investment, growth and employment in utility service industries;
- v. to promote ecologically sustainable development in the provision of utility services; and
- vi. to protect the interests of consumers.

Under the Utilities Act, a number of ACT Codes and Regulations have been developed and issued that impact on the manner and way in which utility services are required to operate, including:

A3 Industry Codes

There are a range of industry codes developed under the Utilities Act which are relevant to the investigation. These include:

- Electricity Capital Contributions Code
- Electricity Network Boundary Code
- Electricity Network Use of System Code
- Electricity Supplier of Last Resort Code
- Gas Capital Contributions Code
- Gas Network Boundary Code
- Water Boundary Code
- Consumer Protection Code

A4 Technical Codes

There are also a range of technical codes developed under the Utilities Act which are relevant to the investigation. These include:

- Electricity Service and Installation Rules Code
- Electricity Distribution Supply Standards Code
- Accreditation Code
- Dam Safety Code
- Franchise Customer Electricity Metering Code
- Management of Network Assets Code
- Emergency Planning Code
- Gas General Metering Code
- Gas Safety and Operating Plan Code
- Water and Sewerage Network Code
- Water Metering Code
- Water and Sewerage Service and Installation Code
- Water Supply and Sewerage Service Standards Code

A5 National Electricity Code

Regulated electricity services are governed by the NEC. The NEC calls for “light handed” regulation of the national electricity market to achieve its objectives, that:

- i. the market should be competitive;
- ii. customers should be able to choose which supplier (including generators and retailers) they will trade with;
- iii. any company wishing to do so should be able to gain access to the interconnected transmission and distribution network;
- iv. a company wishing to enter the market should not be treated more favourably or less favourably than if that company were already participating in the market;

- v. a particular energy source or technology should not be treated more favourably or less favourably than another energy source or technology; and
- vi. the provisions regulating trading of electricity in the market should not treat intrastate trading more favourably or less favourably than interstate trading of electricity.

A7 Relevant extracts from the National Electricity Code

6.10.2 Objectives of the distribution service pricing regulatory regime to be administered by the Jurisdictional Regulators

The *distribution service* pricing regulatory regime to be administered under Part D of the Code must seek to achieve the following outcomes:

- (a) an efficient and cost-effective regulatory environment;
- (b) an incentive-based regulatory regime which:
 - (1) provides an equitable allocation between *Distribution Network Users* and *Distribution Network Owners* of efficiency gains reasonably expected by the *Jurisdictional Regulators* to be achievable by the *Distribution Network Owners*;
 - (2) provides for, on a prospective basis, a sustainable commercial revenue stream which includes a fair and reasonable rate of return to *Distribution Network Owners* on efficient investment, given efficient operating and maintenance practices of the *Distribution Network Owners*;
 - (3) ensures consistency in the application of regulations applicable to:
 - (i) connection to distribution networks;
 - (ii) distribution service pricing; and
 - (4) provides for the recovery by *Distribution Network Service Providers* of *Customer TUOS usage charges* from those *Distribution Customers* that have a *metering installation* capable of capturing relevant *transmission system* and *distribution system* usage data, in a way that preserves the location and time signals of the *Customer TUOS usage prices*;
- (c) prevention of monopoly rent extraction by *Network Owners*;
- (d) an environment which fosters an efficient level of investment within the *distribution* sector, and upstream and downstream of the *distribution* sector;
- (e) an environment which fosters efficient operating and maintenance practices within the *distribution* sector;
- (f) an environment which fosters efficient use of existing infrastructure;
- (g) reasonable recognition of pre-existing policies of governments which are *Distribution Network Owners* regarding *distribution* asset values, revenue paths and prices;
- (h) promotion of competition in upstream and downstream markets and promotion of competition in the provision of *network services* where economically feasible;

- (i) reasonable regulatory accountability through transparency and public disclosure of regulatory processes and the basis of regulatory decisions;
- (j) reasonable certainty and consistency over time of the outcomes of regulatory processes, recognising the adaptive capacities of *Code Participants* in the provision and use of *distribution network* assets;
- (k) reasonable and well defined regulatory discretion which permits an acceptable balancing of the interests of *Distribution Network Owners*, *Distribution Network Users* and the public interest.

6.10.3 Principles for regulation of distribution service pricing

- e) The regulatory regime to be administered by the *Jurisdictional Regulator* must be consistent with the objectives outlined in clause 6.10.2 and must also have regard to the need to:
 - (1) provide *Distribution Network Owners* with incentives and reasonable opportunities to increase efficiency;
 - (2) create an environment in which *generation*, energy storage, demand side options and *network augmentation* options are given due and reasonable consideration;
 - (3) take account of and be consistent with the allocation of risk between *Network Owners* and *Network Users*;
 - (4) take account of and be consistent with any obligations of *Code Participants* in relation to *distribution networks* under Chapter 5;
 - (5) provide a fair and reasonable risk-adjusted cash flow rate of return to *Distribution Network Owners* on efficient investment given efficient operating and maintenance practices on the part of the *Distribution Network Owners* where:
 - (i) assets created at any *time* under a *take or pay contract* are valued in a manner consistent with the provisions of that contract;
 - (ii) subject to clause 6.10.3(e)(5)(i), assets (also known as "sunk assets") in existence and generally in service on 1 July 1999 are valued at a value determined by the *Jurisdictional Regulator* or consistent with the regulatory asset base established in the *participating jurisdiction*;
 - (iii) subject to clause 6.10.3(e)(5)(i), valuation of assets brought into service after 1 July 1999 ("new assets"), any subsequent revaluation of any new assets and any subsequent revaluation of assets existing and generally in service on 1 July 1999 is to be undertaken on a basis to be determined by the *Jurisdictional Regulator*. In determining the basis of asset valuation to be used, the *Jurisdictional Regulator* must have regard to:
 - A the agreement of the Council of Australian Governments of 19 August 1994, that *deprival value* should be the preferred approach to valuing *network* assets;
 - B any subsequent relevant decisions of the Council of Australian Governments; and
 - C such other matters reasonably required to ensure consistency with the objectives specified in clause 6.10.2; and
 - (iv) benchmark returns to be established by the *Jurisdictional Regulator* are to be consistent with the method of valuation of new assets and revaluation, if any, of existing assets and consistent with achievement of a commercial economic return on efficient investment;
 - (6) provide reasonable certainty and consistency over time of the outcomes of regulatory processes having regard for:
 - (i) the need to balance the interests of *Network Users* and *Network Owners*;

(ii) the capital intensive nature of the *distribution* sector, the relatively long lives of *distribution* assets, and the variable and frequent *augmentation* of the *distribution network*;

(iii) the need to minimise the economic cost of regulatory actions and uncertainty;

(iv) relevant previous regulatory decisions made by authorised persons including:

A the initial revenue setting and asset valuation decisions made by a government at a time at which that government was a *Distribution Network Owner* in the context of industry reform pursuant to the Competition Principles Agreement;

B decisions made by *Jurisdictional Regulators* and any regulatory intentions previously expressed; and

C decisions made by ministers under jurisdictional legislation.

Appendix 2: The business structure of ActewAGL

