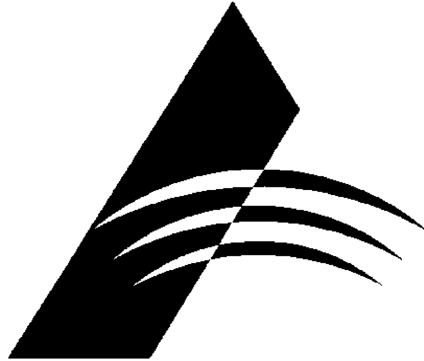

Australian Competition and Consumer Commission

Response to the Productivity Commission Position Paper

Review of the National Access Regime

June 2001

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1. Executive summary

The ACCC is pleased to take this opportunity to comment upon the Position Paper released by the Productivity Commission, *Review of the National Access Regime*.

The Productivity Commission indicates in the introduction to the Position Paper that it has taken an economy-wide review of the operation of Part IIIA. However, as the Productivity Commission notes, there is limited practical experience of the operation of Part IIIA. As a consequence, the ACCC believes that the effectiveness of the national access regime should be judged not only on how it has performed in the past, but also on the extent to which it is likely to be able to deliver the outcomes sought in the future. Thus, comments on the Productivity Commission's Position Paper focus not only upon the impact of the Productivity Commission's recommendations, but also on the issues that they are likely to give rise to in the future.

The ACCC has not attempted to comment on all recommendations. Rather, its comments are limited to those recommendations that it considers may not enhance the effective operation of the national access regime in the way envisaged by the Productivity Commission ,and to the analysis of the Productivity Commission where the ACCC does not believe this analysis supports the Productivity Commission's recommendations.

Objects

The ACCC considers that, in general, objects clauses can be useful in the interpretation of legislation and in informing the exercise of legislative discretion. However, an objects clause is no substitute for clear legislative provisions. While in many respects the Productivity Commission's proposed object is similar to the existing over-arching objective of the *Trade Practices Act 1974*, it does have the potential to change the emphasis of the national access regime because of its exclusive focus on economic efficiency. It is noted that this focus is similar to that proposed by the Hilmer Committee but that when the Part IIIA was introduced, Parliament considered that an object focusing on welfare and competition, which applied more broadly than to Part IIIA alone, was preferable.

Declaration criteria

The ACCC agrees that declaration should only occur if there are non-trivial benefits which exceed the costs of declaration. However, it is suggested that this can be achieved within the existing criteria and that to make changes at this stage, without having demonstrated the need to do so, may in fact create further uncertainty. In particular, with respect to the "tier 1" proposal to require the decision maker to be satisfied that declaration would lead to a "substantial" increase in competition, the ACCC considers that it may be difficult to satisfy this criterion with the degree of certainty required. This is because the future is uncertain as well as the number and variety of factors that will impact upon the level of competition.

Regarding the "tier 1" proposed amendment seeking to ensure that declaration only applies to natural monopoly facilities, the ACCC believes the proposed amendment may not achieve the

intended purpose and, importantly, that there may be occasions where it is appropriate to regulate services provided by facilities with duopolistic characteristics.

In relation to its tier 2 proposed rewrite of the declaration criteria, the Productivity Commission has not established a case. In particular, evidence/examples of inappropriate declarations under the existing criteria are not evident. More importantly, the introduction of new criteria will lead to a period of increased uncertainty until the courts or the Australian Competition Tribunal have made authoritative rulings on the meaning of the new criteria - as has been the case with the existing criteria.

In regard to the Productivity Commission's proposed declaration criteria, a number of comments can be made on individual proposed declaration criteria. For instance requiring the decision maker to assess whether the terms and conditions on which a substitute service is available are "reasonable" is time consuming and resource intensive. In relation to the requirement that the service be significant to the national economy, it is the ACCC's view that this materiality threshold can be achieved through other criteria and is therefore strictly unnecessary.

Arbitration

The Productivity Commission seeks comments on the merit of final offer arbitrations. The ACCC notes that such a mechanism may provide effective incentives where pricing principles are highly prescriptive and when each party has access to all relevant information. Where these circumstances do not exist there remains a high risk of divergent offers and determination by the ACCC of an inefficient access price. It is also inconsistent with the possibility of full merits review; unless the Australian Competition Tribunal was also limited to choosing between the two offers considered by the ACCC.

The Productivity Commission suggests that 30 days after declaration there should be automatic arbitration unless both parties notify the ACCC that settlement is likely. The ACCC considers that this proposal would, in practice, be inconsistent with the proposal to allow undertakings to be given post declaration. In addition, practical implementation issues arise if the Productivity Commission's proposal to limit the involvement of the ACCC as an arbitrator to those terms and conditions notified as being in dispute were to be accepted.

Issues also arise from proposals that the ACCC not have the power to backdate arbitration determinations or to require the extension, or the expansion of the capacity, of a facility.

Undertakings

Two primary issues arise in relation to undertakings. First, the Productivity Commission seeks comments on a proposal to allow non-owners of a facility to offer undertakings. This proposal may have significant benefits in the rail context where interstate track in some States is leased to an operator. Second, practical implementation issues arise both in relation to the possibility of accepting an undertaking where a facility owner would also be covered by a certified access regime and acceptance of post declaration undertakings.

Access holidays

The Productivity Commission states that access regulation can have a "chilling" effect on new investment. It seeks comments on a proposal to allow null undertakings in relation to new investment which may be marginal.

The ACCC considers that such a mechanism would be problematic to operate and may not achieve the desired ends. In particular, because of the lumpy nature of investment in infrastructure, it is common that owners of infrastructure will write generous foundation contracts in the early years, even incurring losses, with the prospect of generating significant returns in later years, once a secure platform of customers has been established. In these circumstances, allowing an exemption from regulation in the early years may be of little practical benefit. Indeed, it is noted that in a submission made by NECG on behalf of a number of service providers, access holidays are not supported.

Pricing and pricing principles

The Productivity Commission has proposed legislating a range of pricing principles. Legislated pricing principles are proposed in order to reduce regulatory discretion and to increase certainty for industry participants. While the ACCC considers pricing principles important, it is concerned about the theoretical and practical validity of the recommended approach:

- the principles proposed are so broad that they are unlikely to achieve the Productivity Commission's stated objectives of improved clarity and certainty;
  - eg, the second of the pricing principles (returns in excess of, but not too far above, costs) is so loosely worded as to be almost meaningless;
- the meaning of the pricing principles is indiscernible unless read in conjunction with the analysis in the Productivity Commission's position paper, something which could not be legislated; and
- more detailed pricing principles embodied in industry-specific codes, in accordance with current practice, is a better approach.

The overlap between Part IIIA and Parts IV & VII

The Productivity Commission recommends that the conduct of an access provider and access seeker in accordance with the terms and conditions of access arrangements should be exempt from exposure to Part IV offence provisions. The ACCC response argues that any such protection should be limited to only those terms and conditions that are specifically approved by the ACCC and should not extend to terms that may be approved by another regulator or terms that are negotiated within the framework of an access arrangement but are not themselves approved.

2. Objects, declarations and price monitoring

2.1 Proposed objects clause

Section 5.2 of the Productivity Commission's Position Paper recommends that an explicit objects clause be inserted in Part IIIA to incorporate short and long-term economic efficiency. The Productivity Commission's particular concern is long-term investment decisions.

Specifically, Proposal 5.1 is that an object of Part IIIA be:

(a) to enhance overall efficiency by promoting efficient use of, and investment in, essential infrastructure services; and
(b) provide a framework and guiding principles for industry specific access regimes.

In general, the ACCC considers the inclusion of a legislated objects clause will assist in the consistent and transparent operation of that legislation. However, an objects clause is no substitute for clearly expressed legislative provisions. For instance, to ensure certainty of the provisions the most important requirement in relation to Part IIIA is clearly defined declaration criterion, and a well-defined and understood list of matters that must be considered in the context of certification, arbitration and assessment of undertakings.

Indeed, as noted by Pearce and Geddes:

> [i]t could not be said that the [objects] clause has always had an influential effect on the interpretation of the Act. ... It has also to be borne in mind when considering an objects clause that it alone will not represent the object of the legislation. Intention is to be gleaned from the whole of the Act and regard must also be had to other sections..[1]

As the Productivity Commission notes, the Hilmer Committee[2] considered that an appropriate over-arching principle might be:

> the promotion of long-term economic efficiency, taking into account the desirability of fostering investment, innovation and productivity improvement, and the desirability of discouraging a person who has a substantial degree of power in a market from using that power to set prices above efficient levels.

There are parallels between the objects proposed by the Hilmer Committee and those proposed by the Productivity Commission. In framing Part IIIA, however, the legislature considered the report of the Hilmer Committee and determined not to adopt the approach in precisely the terms suggested by the Hilmer Committee. Instead it a decided to utilise the existing objects of the Trade Practices Act. Section 2 of the Trade Practices Act provides that the object of the Act is:

> to enhance the welfare of Australians through the promotion of competition....

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1 D C Pearce & R S Geddes *Statutory Interpretation in Australia* third edition, 1988, Butterworths at p 90.
2 Independent Committee of Inquiry into a National Competition Policy 1993, *National Competition Policy* (F G Hilmer, Chairman), AGPS, Canberra.

Indeed, the overarching object of the Act was amended at the time Part IIIA was inserted[3].

It is also important to consider what is meant by "economic efficiency" in the proposed object and how significant a shift away from the existing object the proposal would be. The Australian Competition Tribunal has discussed the meaning of "economic" and "uneconomical".

The Tribunal indicated that both terms needed to be understood from a broad social cost-benefit sense, rather than a narrow accounting or profitability perspective.[4]

While the concept of "economic efficiency" entails a measure of social desirability, it focuses on the productive, allocative and dynamic dimensions of a market, without regard to any distributional issues.

In many ways, this concept of "economic efficiency" promoted by the Productivity Commission is closely aligned with the concept of "welfare", included in the existing object in section 2 of the Act. Section 2 emphasises promotion of competition but, as noted in paragraph 63 of the Australian Competition Tribunal's Eastern Gas Pipeline decision, competition "provides a very powerful means of securing important gains in allocative and ... dynamic efficiency".

The Productivity Commission argues that using competition as a proxy for efficiency does not recognise that an emphasis on competition may promote the entry of too many competitors, which is itself inefficient. The Productivity Commission says that:

> Hence, the objectives of Part IIIA need to recognise that the promotion of competition is desirable from the community perspective only when such competition is efficient.[5]

However, inefficient competition would also be inconsistent with the concept of welfare in the existing object.

As the Tribunal makes clear in paragraph 64 of the Eastern Gas Pipeline decision, infrastructure owners decide whether or not to construct new infrastructure on the basis of private cost rather than social cost issues. Thus, it is difficult to say that by changing the emphasis from "the promotion of competition" to "the efficient use of, and investment in, infrastructure" there will be a significant change in incentives such that new infrastructure facilities will only be constructed where it is economically efficient, from the social perspective, to do so.

2.2 Declaration criteria

The Productivity Commission recommends changes to the existing declaration criteria in Part IIIA. Proposal 6.1 recommends fine tuning the declaration criteria. Proposal 6.1 is a Tier 1

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[3] Act No 88 of 1995.

[4] In *Re: Review of Freight Handling Services at Sydney International Airport (2000) ATPR#41-754* and in the recent *Duke Eastern Gas Pipeline Pty Ltd [2001] ACompT2.*

[5] Refer to Position Paper, page 90.

suggestion that the Productivity Commission believes will have a clear benefit for the community. Essentially it recommends amendments to subsections 44G(2)(a) and 44G(2)(b). According to the Productivity Commission, the former section would be amended to allow declaration only to occur if the decision maker is satisfied that to do so would lead to a "substantial increase" in competition. This is contrasted with the existing test which requires only that the decision maker be satisfied that declaration would "promote competition".

The proposed amendment to subsection 44G(2)(b) would allow declaration where it is uneconomical to develop a "second facility", rather than "another facility" as is currently the relevant test.

Proposal 6.2 is a complete re-write of the section 44 declaration criteria. The Productivity Commission suggests this re-write as a Tier 2 proposal, which would offer further gains but which may also have significant implementation costs. Proposal 6.2 is reproduced below at section 2.2.2.

The ACCC considers that both the Productivity Commission's Tier 1 and Tier 2 proposals would have significant implementation costs. Given that there are no examples of the existing criteria leading to inappropriate declarations, the ACCC would have concerns if the amendments proposed by the Productivity Commission were to proceed. It is considered that courts would strive to give meaning to the new criteria so as to differentiate those criteria from the existing provisions, which the Commission considers have operated appropriately. This may in fact lead to greater uncertainty.

Proposals 6.1 and 6.2 are discussed below in turn.

2.2.1 Proposal 6.1

(a) Substantial increase in competition

The Productivity Commission argues that services should not be declared unless declaration would have a material effect on the degree of competition. Underlying this proposal is a concern that the existing criteria (a) allows the declaration of services, where the impact upon competition is marginal.

The ACCC considers that it is too early to hold such a concern - there being no evidence of inappropriate declaration under the existing criteria. Indeed, the only decision equivalent to a declaration that has been overturned by the Australian Competition Tribunal is the decision by the Minister for Industry, Science and Resources published on 16 October 2000 under section 38 of the Gas Pipeline's Access Law to cover the Eastern Gas Pipeline pursuant to the provisions of the National Third Party Access Code for Natural Gas Pipeline Systems. In that matter, the relevant Minister was required to be "satisfied that the access (or increased access) to services provided by means of the pipeline would promote competition in at least one market ..." [Section 1.9 (a)]. The basis of the Tribunal decision[6] was that Eastern Gas Pipeline did not have

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6 Refer to paragraph 124.

market power and that the Tribunal could not therefore be satisfied that coverage would promote competition in either upstream or downstream markets.

In these circumstances, the ACCC considers that the proposed change would in fact be detrimental. It is only recently that judicial decisions have started to clarify the meaning of the existing declaration criteria, resolving some of the uncertainties around the existing tests. Strictly, amendments to the existing criteria should only be made where there is a clear benefit in doing so. The ACCC does not consider that the Productivity Commission has demonstrated a case for change.

Indeed, to change the declaration criteria now could lead to further uncertainty until such time as judicial decisions can clarify the meaning of any new criteria.

This is particularly so given that subsection 44(G)(2)(f), the public interest criteria, already permits consideration to be given to how the potential costs of declaration compare with the potential benefits arising from an increase in competition.

The ACCC is also concerned that the concept of a "substantial increase in competition" may itself be uncertain. As the Productivity Commission has highlighted, in the context of competition and market power, the concepts of "substantially damaging", "substantially lessening", or "a substantial degree" already appear in Part IV of the Act. However, it is a concept with which the courts have had difficulty. Indeed, Deane J said in *Tillmanns Butcheries Pty Ltd v Australasian Meat Industry Employees' Union* (1979) 42 FLR 331,348:

> The word " substantial" is not only susceptible to ambiguity; it is a word calculated to conceal a lack of precision. ... It can be used in a relative sense or can indicate an absolute significance, quantity or size... [in the context of section 45D substantial loss or damage] includes loss or damage that is real or of substance and not insubstantial or nominal.

It is also difficult to know how a decision maker could be satisfied that access (or increased access) would lead to an increase in competition that was real, or of substance. The test requires determination with certainty; there is no scope to assess the likelihood or probability of an increase in competition. The decision maker would be required to examine the future with and without the declaration. Although such a with and without test is understood in the context of competition law, it is one that requires the decision maker to isolate effects which are likely to occur as a result of declaration. In the case of the Productivity Commission's proposed test, it would be necessary to be satisfied that the effects will definitely occur as a result of declaration. Given that many aspects of the future will be speculative, and the number and variety of factors that will impact upon the level of competition, it would be almost impossible for a decision maker to be able to predict the future with sufficient certainty for declaration. One of those factors that will determine the impact of declaration is the terms and conditions upon which access is available. These are not set, and the ACCC would argue should not be set, at the time of declaration.

Moreover, the ACCC considers that, while it may be appropriate to measure the degree of market power or lessening of competition in Part IV, that test is not transferable to Part IIIA. Part IV attempts to regulate the behaviour of firms by proscribing certain conduct. In a normal

competitive market a firm will seek to maximise its market share. This will entail, by necessity, some degree of trying to gain an advantage over its competitors. In creating an offence in relation to certain conduct that is deemed to be unacceptable, it is necessary to include some measure of the degree to which competition is affected. However, in a case of markets for essential services that display monopoly characteristics, the ACCC does not consider it would be appropriate that such a measure of materiality, particularly associated with the degree of certainty envisaged, is appropriate. The welfare benefits of access to such bottleneck facilities that were identified by the Hilmer Committee are such that it is inappropriate to place such a high hurdle upon declaration.[7]

(b) Natural monopoly

The Productivity Commission also argues that a service should not be declared unless it is uneconomic for anyone to develop a "second facility". This is contrasted with the existing provision in s44G(2)(b) which requires the decision maker to be satisfied that it would be uneconomic to develop "another facility".

While it is clear that this declaration criteria will most often ensure that the national access regime applies only to facilities with monopoly characteristics, the ACCC remains of the view that there may be circumstances where it is appropriate that access be available in relation to natural duopolies or oligopolies. In addition, the ACCC does not consider that the amendment proposed will be effective to ensure that only natural monopoly services are declared. For both these reasons, the ACCC does not support the Productivity Commission's proposed amendments to section 44G(2)(b).

The proposed test implies that an unconstrained duopoly would represent a sufficient advance on (constrained) monopoly to satisfy the Productivity Commission's efficiency objective. However, the Productivity Commission's own review of the duopoly literature concludes that "most theoretical and simulation findings suggests that duopoly pricing will tend to be nearly as inefficient as monopoly".[8] It is difficult to see the advantages of a test which would effectively eliminate the possibility of declaration where a market was served, or likely to be served, by an unconstrained duopoly.

In the recent Eastern Gas Pipeline decision the Australian Competition Tribunal considered the meaning of a similar provision in section 1.9 of the National Third Party Access Code for Natural Gas Pipeline Systems. Section 1.9 (b) provides as follows:

> that it would be uneconomic for anybody to develop another Pipeline to provide the Services provided by means of the Pipeline.

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7 Estimates indicate that the benefits of electricity and gas reform are likely to be substantial, in the order of $5.8 billion (in 1993–94 dollars) or 1.4 per cent of gross national income. This benefit was the largest single benefit in the overall Hilmer and related reforms estimated by the IC (Industry Commission, *The Growth and Revenue Implications of Hilmer and Related Reforms: A report by the Industry Commission to the Council of Australian Governments (Final Report),* Australian Government Publishing Service, Canberra, March 1995).

8 Productivity Commission, *Telecommunications Competition Regulation*, Draft Report, page 8.17.

The Tribunal having decided that the service being provided by the Eastern Gas Pipeline was the haulage of gas between Longford and Sydney (thus excluding from consideration in relation to this criterion the Moomba to Sydney pipeline), it considered whether the existing facility (that is, the Interconnect between the transmission networks of Victoria and the New South Wales) supplied services in competition with the Eastern Gas Pipeline.[9] This led the Tribunal to the test it adopted[10] for the assessment of criterion 1.9(b).

> [The] test is whether for a likely range of reasonably foreseeable demand for the services provided by means of the pipeline, it would be more efficient, in terms of costs and benefits to the community as a whole, for one pipeline to provide those services rather than more than one.[11]

Based on the demand forecasts and the cost of expanding the Interconnect relative to the cost of the Eastern Gas Pipeline, the Tribunal determined that it would be uneconomic to develop the Interconnect to supply Sydney with its anticipated requirements of gas from Longford.

In other words, the Tribunal looked at the economics of expanding the competing pipeline. If the application of the test adopted by the Tribunal is correct, a change in the criteria as proposed by the Productivity Commission, will make application of the test ambiguous and difficult in circumstances where one or more pipelines already exist. It may not prevent declaration of the service where an alternative and competing service already exists if that competing service is unable to meet demand and could not, economically, be enhanced to do so. In other words, it may allow regulation of natural duopolistic services and natural oligopolistic services.

As noted above, the ACCC continues to believe that there may be circumstances in which regulation of the duopolistic services may be warranted. One example may be where such services are supplied by vertically integrated providers. If downstream services are supplied by two oligopolistic firms and each firm owns a facility that is used to provide services that are essential inputs in the downstream market, the incumbents will have little incentive to provide access to those facilities to a new entrant. In these circumstances, access regulation may be appropriate. The leasing by incumbent airlines of airport terminals may be an example of just such a situation.

2.2.2 Proposal 6.2

The Productivity Commission considers that, even with the more limited amendments to the existing declaration criteria in section 44G, important deficiencies would remain. In particular, the Productivity Commission is concerned that the residual public interest criterion [criterion (f)] is the only means by which efficiency may be considered.

Thus the Productivity Commission has proposed a more fundamental restructuring of the declaration criteria. This proposal is in line with the Productivity Commission's proposed amendments to the declaration criteria found in Part XIC of the Act.

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9 Paragraph 55.

10 Paragraph 137.

11 While this test was developed by the NCC and adopted by the Tribunal, it does not sit comfortably with the wording of the existing test. The proposed amended test would have the same difficulty of application.

The Productivity Commission's proposed second tier declaration criteria are as follows:

- that the service is of significance to the national economy and the entry of a second provider of the service would not be economically feasible;
- no substitute service is available under reasonable conditions that could be used by an access seeker;
- competition in downstream markets is insufficient to prevent the provider of the service from exercising substantial market power;
- addressing denial of access, or the terms and conditions of access, to the service concerned is likely to improve economic efficiency significantly;
- access to the service is not already the subject of an effective access regime; and
- access (or increased access) to the service would not be contrary to the public interest.

These proposed declaration criteria would be a less significant departure from the existing criteria in Part IIIA than they would be in Part XIC. This is because, as currently drafted, Part IIIA already provides a range of criteria, all of which must be satisfied before a service can be declared. In contrast Part XIC allows the ACCC significant discretion.

The Productivity Commission has not pointed to particular instances in which a declaration has been inappropriately made using the existing declaration criteria in Part IIIA.

In this regard, it is important to emphasise that, whatever the merits of the approach proposed by the Productivity Commission, mere amendment of the criterion will lead to greater uncertainty. As noted above, it is only recently that authoritative interpretations of the existing criteria have been available to assist all parties. In the absence of any clearly demonstrated shortcomings in the existing criteria, the costs related to amending the criteria may in fact outweigh the advantages at this stage.

The proposed declaration criteria

It appears that the first criterion is intended to be the major limiting criterion (what the Productivity Commission refers to as the screening test), broadly identifying the situations in which declaration is likely to be appropriate; viz. natural monopoly services. Subsequent criteria then provide refinement by excluding particular instances where declaration would be inappropriate.

(a) Natural monopoly services

Declaration could only occur where entry to the market of a second provider would not be economically feasible. This raises two main issues on which the ACCC proposes to comment:

- the case for limiting regulatory intervention to infrastructure with natural monopoly characteristics; and
- the manner in which the Productivity Commission has sought to define natural monopoly.

From its declaration test, the Productivity Commission appears to have defined natural monopoly as the situation where entry to a market by a second provider would not be economically feasible. In the ACCC's view, such a definition would appear to be restrictive and would exclude situations in which declaration would be appropriate.

For the reasons discussed in section 2.2.1 above, the ACCC queries whether, having regard to the test applied by the Australian Competition Tribunal, the proposed formulation of the natural monopoly test will achieve the outcome sought by the Productivity Commission.

(b) Significance of the service to the national economy

The requirement for "significance" suggests a test of materiality. The ACCC agrees that ensuring that declaration does not occur where the benefits are small or trifling is worthwhile. However, it would seem that the materiality threshold is achieved through a subsequent criterion, namely the fourth criterion, where it must be shown that addressing denial of access, or the terms and conditions of access, is likely to improve economic efficiency *significantly*. It would seem repetitive and potentially wasteful of resources to have two materiality tests.

(c) Substitute wholesale services and downstream competition

The Productivity Commission suggests that, in some situations where a facility (by which the service is supplied) is a natural monopoly, the facility operator may not be able to exercise market power because of production and/or consumption substitutes. In such a situation, it appears the Productivity Commission would regard declaration as being inappropriate - the object of the second and third criteria is to exclude these situations.

It is not clear to the ACCC that these criteria are necessary to deal with such instances. This is because, where production or consumption substitutes prevent a service provider from exercising market power, it is unlikely that the first criterion would be satisfied.

Relevantly, the first criterion will not be satisfied unless it can be shown that is it not economically feasible for a second provider to enter the market for those services.

If a substitute service is available to access seekers under reasonable conditions (ie, a production substitute), then it would appear that barriers to entering the market for the service are not substantial. Moreover, where the substitute service is supplied by another operator, this indicates that at least one other provider has entered the market, thereby suggesting that it is economically feasible to do so.

Similarly, if consumption substitutes mean that downstream competition is sufficient to prevent the exercise of substantial market power with respect to the (wholesale) service, then the market

in which the wholesale service is supplied can include those downstream services. As noted by the ACCC in its Mergers Guidelines:

> … vertically stages adjacent … may still be relevantly included in the same functional market if close substitution possibilities, either product and/ or geographic, at the adjacent level (and occasionally between levels) would constrain the … firm from imposing a significant increase in price, or equivalent exercise of market power. For example, in *QIW* the Tribunal defined a single functional market for the distribution of groceries to the public, including wholesale and retail stages, reflecting the constraint imposed on the conduct of independent wholesalers by downstream competition between their independent retail customers and the vertically integrated chains.[12]
>
> Even if those downstream services are not included in the market, the inputs used to supply those downstream services will be included in the market to ensure that all relevant competitive constraints are taken into account.

Consequently, where downstream services constrain the behaviour of the service provider, it is unlikely that the first criterion will be satisfied. This is because the market is unlikely to be characterised by substantial barriers to entry and it would seem economically feasible for a second provider to enter the market.

(d) Assessing reasonable conditions

Where substitute services are available, the second criterion would require the decision maker to assess whether the terms and conditions on which they were available are "reasonable". This could be a very time-consuming and resource intensive task, particularly where the decision maker needs to assess the price on which the substitute service has been made available.

- For instance, to conclude that a service was not available on reasonable terms and conditions, the decision maker would need to establish a "benchmark" by which reasonableness would be assessed.

In the context of pricing, the benchmark may be efficient costs of production. Estimating these costs may be time and resource intensive. It is also likely to be information intensive with high costs associated with gathering significant amounts of information, much of which may be commercially sensitive.

(e) Improving economic efficiency significantly

The ACCC agrees with the sentiment underpinning this criterion - declaration should only occur where it is likely to produce efficiency benefits, broadly defined, encompassing allocative, productive and dynamic efficiency. That said, the manner in which this criterion is worded could cause significant delays to the declaration process.

According to this criterion, before declaring a service the decision maker would need to be satisfied that addressing the denial of access, or the terms and conditions of access, is likely to improve economic efficiency significantly. The impact of terms and conditions of access on

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[12] Australian Competition and Consumer Commission, *Merger Guidelines*, June 1999, para. 5.67.

economic efficiency is, however, highly dependent upon the pricing that the decision maker would be likely to regard as reasonable.

This means that if the decision maker is to determine the extent to which addressing the terms and conditions of access is likely to improve economic efficiency, then it would need to conduct a pricing study at the time of considering whether to declare a service.

- This would be contrary to the general approach underpinning Parts IIIA and XIC of the Act, whereby declaration and determination of access prices (and other terms of access) are two discrete stages occurring at separate times.

- It would also seem to involve a greater degree of regulatory intervention, with the decision maker providing its view on access terms and conditions at the time of declaration, rather than giving the parties a chance to sort out these issues post-declaration before recourse to the ACCC.

- In the context of Part IIIA, as it is currently drafted, it would also require two separate regulatory bodies to investigate and form a view on access terms and conditions. This is not only wasteful of resources but may lead to some uncertainty if divergent views emerged about any issues.

Refer also to 2.2.1 above.

2.3 Price monitoring

In section 6.4 of its report, the Productivity Commission states its support for price monitoring as an alternative to declaration. It argues that a regulator faced with a marginal declaration should, instead, be able to implement price monitoring of a particular service to collect information on prices and costs. It considers this would both allow the regulator to assess the significance of any market power held by the facility owner and be an effective constraint on prices charged by the facility owner.

The ACCC considers that price monitoring may be a useful additional tool. However, it is not an effective substitute in that it will not provide a mechanism for a firm wishing to gain access to services provided by an essential facility in order to compete in an upstream or downstream market. If the declaration criteria are designed to identify services to which a facility owner may have an incentive to deny access, any service satisfying the declaration criteria must be subject to the access regulation.

Even if the cause of inefficiency is the charging of monopoly rents, as opposed to the denial of access, the substitution of price monitoring for the existing rights to access at a fair and reasonable price (arbitrated if necessary) would inappropriately “water down” the benefits that the access regime can offer to upstream and downstream competition and efficiency.

One possible instance where price monitoring may be appropriate is where the only reason the regulator is satisfied that the service meets the declaration criteria is its concern about the likelihood of parallel pricing behaviour or collusion.

If price monitoring was adopted, information requirements would need to be specified, and this would necessitate the development of appropriate accounting guidelines. Such guidelines may need to specify a cost allocation methodology that differs between activities that are declared and those that are not. To be effective, price monitoring would need to be based on efficient costs. There will be instances, particularly when there is vertical integration, where there is an opportunity for the facility owner to inflate input costs. Even in situations where there is no vertical integration there may be issues surrounding the allocation of costs.

Price monitoring is seen as light-handed regulation because it does not allow a regulator an opportunity to set an access price or revenue cap. But the ACCC considers price monitoring is not a significant deterrent to a facility owner extracting excessive rents. This is particularly true where price monitoring is undertaken over a number of years and there is no clear and significant consequence for charging excessive prices.

3. Arbitration and undertakings

3.1 Arbitration

In sections 6.5 to 6.7 the Productivity Commission makes a number of recommendations and seeks comments on a number of other issues relating to arbitrations and undertakings.

3.1.1 Final offer arbitration

The Productivity Commission seeks comments on the merit of final offer arbitrations. This is where the arbitrator chooses between the terms and conditions proposed by the access provider and those proposed by the access seeker. The regulator is limited to these offers and cannot impose other terms and conditions. The Productivity Commission notes that final offer arbitration would be difficult where there were widely divergent proposed prices. It suggests that the inclusion of pricing principles in the legislation would guide price setting behaviour under the regime, thus giving rise to more favourable conditions under which to conduct final offer arbitration.

This assumes pricing principles that are highly prescriptive. Even so, the ACCC considers it unlikely that the proposed pricing principles would provide this level of certainty. The ACCC's comments on the Productivity Commission's proposed pricing principles are in section 4 of this submission.

The ACCC also notes that, even if the pricing principles offered precise guidance, if there was information asymmetry between the parties to the arbitration the risk that divergent offers would be made, and an inefficient price set, would remain high. There would also be a risk, if pricing was divorced from an understanding of the revenue requirements of a business, that the regulator may choose a price with the potential to bankrupt an access provider.

3.1.2 Backdating arbitrations

The Productivity Commission concludes that it would be inappropriate to amend the arbitration provisions of Part IIIA to permit the ACCC to backdate arbitration determinations because Part IIIA does not provide a mandatory right of access. While there is no equivalent to the standard access obligations provided for in Division 3 of Part XIC, the ACCC does not accept that for backdating provisions to be effective, Part IIIA would require significant amendment. Once declared, the ACCC can make an arbitral determination requiring the provision of access [see section 44V(2)].

The important point if a provision allowing for the backdating of arbitrations is to provide an effective incentive to negotiate terms and conditions of access is not whether Part IIIA provides a

mandatory right of access, but whether the access seeker has access to the declared service at the time the dispute is notified. This may or may not be the case.

However, as the arbitration provisions clearly envisage that disputes may arise in relation to services to which access has already been given, the ACCC considers that a provision allowing for the backdating of arbitral determination is warranted. Backdating is important because it removes any incentive a facility owner may have to delay the negotiation and arbitration processes.

3.1.3 Automatic arbitrations

The Productivity Commission's proposal 6.4 (a second tier proposal) is that arbitrations commence automatically 30 days after declaration of a service, unless both the parties notify the ACCC that settlement is likely. This suggestion is made having regard to the Productivity Commission’s view that it would be inappropriate, in Part IIIA, to backdate arbitration determinations. This is discussed above. Instead, the Productivity Commission considers that automatic arbitration would be a more appropriate means to facilitate speedy resolution of disputes.

The ACCC notes that under section 44S(1) the threshold for the notification of a dispute is that: “a third party is unable to agree with the provider on one or more aspects of access to a declared service...”. In these circumstances either the access provider or the third party, access seeker, is entitled to notify a dispute. Regulation 6C requires that the notifier of an access dispute supply (inter alia):

(f) a description of the access dispute;

(g) a description of the efforts, if any, to resolve the dispute...

The threshold for notification of a dispute is therefore extremely low and it is open to either party, in particular the access seeker, to notify a dispute.

The ACCC also considers this proposal to be inconsistent with the proposal to allow undertakings to be offered after declaration. This issue is discussed at section 3.2.1.

3.1.4 Multi-lateral arbitrations

The Productivity Commission finds that it would not be appropriate to allow multi-lateral or public processes to be used to provide faster, more effective and more transparent price determinations.

In part, this finding is based on the view that for the services likely to be declared under Part IIIA it is likely that access would only be sought by a small number of parties. In this regard, Part IIIA is contrasted to Part XIC.

Instead, the Productivity Commission regards the proposal to allow undertakings to be lodged both before and after a service has been declared will provide for sufficient flexibility in

circumstances where there may be a class of access seekers for whom a multi-lateral arbitration process may otherwise be useful. While the ACCC supports the proposal to allow undertakings to be lodged after a declaration is made, it does not consider that this proposal is a substitute for multi-lateral arbitrations. While there remains no provision for compulsory undertakings, this proposal relies on the goodwill of the access provider.

Section 6.6 does not raise any in-principle objections to multi-lateral arbitrations. Notwithstanding that the occasions when they may be used may be infrequent in Part IIIA, the Productivity Commission acknowledges that there may in fact be some such occasions. In these circumstances, the ACCC considers that allowing the regulator a discretion to conduct multi-lateral arbitrations, after seeking comments from the parties, would be useful.

3.1.5 Scope of arbitration

The Productivity Commission proposes that "in arbitrating terms and conditions for declared services, the ACCC should limit its involvement generally to matters in dispute between the parties". This proposal is based on the view that reopening issues upon which agreement has been reached is unnecessary, time-consuming and may involve "micro-managing commercial operations". While the Productivity Commission acknowledges that there would be a need for the ACCC to be made fully aware of agreed matters to ensure that a particular determination would not have implications for other matters previously agreed, the proposal gives insufficient weight to the fact that terms and conditions of access need to be considered as a whole. It may not be possible to look at price in isolation from other terms and conditions.

The Productivity Commission uses the agreement between Melbourne Airport and Impulse Airlines over pricing for common user facilities as an example of a matter in which it alleges the ACCC inappropriately reopened matters that had been commercially agreed. However, this issue did not arise in the context of an arbitration. Instead, it arose in the context of a price notification under the *Prices Surveillance Act 1983.* In that matter, the ACCC was required to consider an application to introduce new charges at Melbourne Airport against certain legislative criteria, one of which was the attitude of users of the facility. The users of the facility included airlines other than Impulse who had not agreed to the proposed price. It is therefore not an example of the inappropriate examination of agreed terms and conditions.

Indeed, in the context of arbitrations under Part XIC of the Act, the ACCC has generally sought to reduce the number of matters in dispute, in relation to which a determination is required.

A further issue arising from this suggestion is the additional significance it places upon the terms of the notification. In the experience of the ACCC, the matters in dispute may change over time from the date of notification of the dispute to final determination. Not only will matters in dispute be settled but new issues can be disputed. In these circumstances, there would be dangers in limiting the ACCC to only those matters originally in dispute. At the very least, there would need to be flexibility for the notifier to vary the terms of the notification. It is also possible that the notification will not necessarily cover all issues in dispute. There may be reasons why the notifier does not include matters of particular interest to the other party in the notification. It would also therefore seem necessary to allow a party other than the notifier to vary the terms of the notification.

3.1.6 Directions to extend facilities

The Productivity Commission proposes to remove the ACCC's power to require an extension of a facility as part of an arbitration determination (Proposal 6.8). The discussion in that section makes it clear that the reference to "extension" is not limited to geographic extension, but also includes a capacity expansion. The Productivity Commission considers that such a power is an unwarranted intrusion into private property rights. Essentially, it is argued that if a facility owner decides to build a facility to sub-optimal capacity to avoid regulation, it should have the right to do so.

The ACCC considers that such an amendment would run counter to the objectives of competition reform. The purpose of allowing access to the essential facilities proposed by the Productivity Commission is to "enhance overall economic efficiency by promoting efficient use of, and investment in, infrastructure services...". If the ACCC were to be prevented from requiring the expansion of a facility with sub-optimal capacity (that is, an economically inefficient facility), the national access regime would, in a very substantial way, be inconsistent with the proposed legislative objects.

If the ACCC does not have the power to require extensions or expansions, a facility owner may have an incentive to maintain inefficient levels of investment.

A facility owner may have market power merely by virtue of the fact that it controls a facility that has monopoly characteristics and provides essential services. The introduction of the national access regime was designed to curb this market power and, through more efficient use of that facility, promote competition in upstream and downstream markets. However, a facility owner may also have market power from the fact that the demand for the essential services is greater than the capacity of the facility in circumstances where it would, at that time, be inefficient to develop a completely new facility. The ACCC can see no justification for the legislature imposing access prices upon a facility owner where capacity is available, and allowing the facility owner to earn monopoly rents in circumstances (possibly contrived) where the facility has no spare capacity.

Indeed, these circumstances currently exist on the Moomba to Adelaide pipeline. A reference tariff has been set by the ACCC for third party access. The pipeline is fully compressed and demand exceeds capacity. The pipeline owner has the potential to earn monopoly rents by agreeing, outside the queuing policy, to carry gas where the access seeker agrees to pay rates in excess of the reference tariffs. It would be significantly more efficient for the pipeline owner to gradually develop a parallel pipeline by looping the existing pipeline, than for a new entrant to develop a completely separate pipeline that duplicates the service currently being provided by the Moomba to Adelaide pipeline. Any change to prevent the ACCC requiring capacity expansion has the potential to hand back to facility owners monopoly power in situations where demand approaches or exceeds capacity.

The ACCC also notes that subsection 44W(1)(e) provides that a determination must not require the access provider to bear some or all of the costs of extending a facility or maintaining extensions of a facility.

3.1.7 Post-arbitration report

In chapter 9, the Productivity Commission recommends[13] that the ACCC be required to publish post-arbitration reports and seeks comments on how much detail of the arbitrated terms and conditions should be included in the reports.

It is considered that it would be difficult to describe exactly what type of information could be published in such a report. Consequently, there will need to be a degree of discretion provided for the regulator. It is noted that section 5.2 of the National Third Party Access Code for Natural Gas Pipeline Systems allows the Relevant Regulator to require the provision of access information unless, in the regulator's opinion, "disclosure could... be unduly harmful to the legitimate business interests [of the facility owner]". A similar formulation could be used in the national access regime.

3.2 Undertakings

3.2.1 Post declaration undertakings

The Productivity Commission proposes that access providers should have the ability to lodge undertakings after a service has been declared.[14]

It is noted that difficult practical issues would arise if an access provider lodged an undertaking shortly after the declaration of a service, and if the legislation also required the ACCC to commence arbitration if no negotiated agreement for access had been reached within 30 days. One possible solution would be to allow an undertaking to be lodged and considered at the same time an access dispute was under consideration and to give priority to an undertaking that had been accepted, but allow the ACCC to impose a determination if it did not accept the undertaking. It would be necessary to provide a mechanism for information received as part of the public process involved in the assessment of an undertaking to be considered in relation to the determination of an access dispute, which is essentially private. Conversely, issues may arise where it may be inappropriate to use in a public (undertaking) process, information provided in the course of a private arbitration.

3.2.2 Non-owner undertakings

Section 44ZZA states that:

> a person who is, or expects to be, *the provider* of a service may give a written undertaking to the Commission in connection with the provision of access to the service (emphasis added).

"Provider" is defined in section 44B to mean ("unless the contrary intention appears"):

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[13] Proposal 9.9.

[14] See section 7.3.

> the entity that is the *owner* or *operator* of the facility that is used (or is to be used) to provide the service (emphasis added).

"Owner" refers to the entity in whom the title to, or ownership of, a facility is vested. The term "operator" is not defined in the Act. It is not a legal concept. The precise scope of this concept is difficult to ascertain with certainty. Nevertheless, the notion of control over the working/functioning of the facility seems to be at the heart of the concept.

This interpretation seems to be consistent with the legislative intention and approach taken to the access issues identified by the Hilmer Committee. An entity that provides services by means of the facility, but does not have control over the asset, does not have the capacity to either obstruct the use of the facility or extract monopoly rents from the exploitation of the facility. Because it is the facility (not the service) that is the natural monopoly, such an entity should not be regulated. To extend the notion of "provider" beyond those with close control over the underlying facility would radically extend the operation of Part IIIA beyond that intended.

Thus, the ACCC considers that to be a "provider" under Part IIIA an entity must be able to (or "have the legal power or right to") provide the service to which access is sought pursuant to the undertaking. The ACCC acknowledges that the problem identified by the Australian Railtrack Corporation is a real one. The ACCC would support an amendment that would clarify the ability of the Australian Railtrack Corporation to offer an undertaking to the entire interstate railway network.

The simplest method of achieving this outcome would appear to be to allow a firm that was not "the provider" of a service to offer an undertaking if it had the consent of the owner of the facility. It would be incumbent on access seekers to satisfy themselves that the level of control exercised by the entity providing the undertaking was sufficient for the purposes of granting access to the facility.

3.2.3 Access holidays

- In section 7.3 the Productivity Commission expresses the concern that access regulation can have a "chilling" effect on new investment. The Productivity Commission considers that marginal investment should not be subject to regulation and argues that a limited form of exemption, via the provision of a null undertaking, is a preferable mechanism to deliver such an exemption than a blanket exclusion.

- While the concept of a null undertaking (access holiday) may have some theoretical appeal, the ACCC considers that such a mechanism would be problematic to operate and may not achieve the desired ends.

- The Productivity Commission indicates that the proposal is aimed at preventing the possibility of a diminution of expected returns as a result of exposure to access regulation. Behind this statement is the proposition that a firm investing in marginal bottleneck infrastructure should have a right to charge whatever it chooses, free from regulation.

- One of the practical problems that would arise in relation to the provision of null

undertakings is that, to be of any use, a prospective investor would need to be certain that a null undertaking would be accepted prior to the commencement of a project. Before a null undertaking could be accepted, the ACCC would need to be provided with sufficient information about the prospective project to make a determination.

- As the Productivity Commission points out, this would need to include some information to allow the ACCC to consider whether the investment truly related to a "new service". It would also be necessary to have information about the proposed costs of the project, the proposed price of services and the forecast demand. Clearly, the issue of asymmetrical information between the service provider and the regulator would also be crucial.

- It would be very difficult for the ACCC to assess the reasonableness of information provided, including anticipated demand figures. It would also only be possible for the ACCC to accept such an undertaking on the basis that the information provided at the time prior to the project's commencement remained accurate at the time the project came on stream. This raises a number of difficulties. Some projects have such long lead times that the ACCC might be asked to assess the reasonableness of predictions a long time before access to the service becomes an issue. Another issue would arise if, for instance, the access provider changed the price at which the service was to be supplied after the ACCC had assessed the application for a null undertaking. Would the null undertaking be voided?

In addition to identifying those projects that might meet certain criteria to qualify for a null undertaking, there are practical difficulties in determining the conditions relating to the access holiday. These include the appropriate duration of the holiday and the access regime to apply once the holiday has ended.

In addition to these practical difficulties, the ACCC is of the view that a null undertaking may not achieve the outcome desired. Investment in infrastructure is lumpy. In the early years of the operation of a new facility, the service provider may have market growth as its prime objective and incur below normal profits (or losses) during that period. It is only in later years once the market has grown that the service provider earns above normal returns to recoup any early losses. In these circumstances, a null undertaking may be of little effect unless of extremely long duration.

On the other hand, there may be circumstances where a facility owner does not have an incentive to fully utilise the capacity of a facility. An example of such a situation would be where the facility owner is vertically integrated into upstream or downstream markets. In these circumstances, to allow the facility owner to offer a null undertaking means that the facility owner will be able to deny access to potential competitors in those upstream or downstream markets. This may allow the facility owner to artificially cement its position in those markets, possibly because of a first mover advantage. This may overcome the "chilling effect" of regulation on investment; however, it would also have a "chilling effect" on competition upstream and downstream and, through competition, economic efficiency and social welfare.

Significantly, the concept of access holidays is no longer supported by numerous industry participants, including some infrastructure owners. In a joint industry submission to the

Productivity Commission's position paper, the Network Economics Consulting Group (NECG) states:

> We do not think an access holiday provides the answer for investors concerned about regulatory risk. Any holiday that would remove the risk that returns for successful projects may be truncated by regulatory intervention would have to occur towards the end of the project, not at the beginning of the project (when returns are below the cost of capital).
>
> Instead, we suggest that the Commission consider the scope for regulated firms to be given some assurance *ex ante* that the additional risks they are bearing will be reflect (sic) in regulated access prices.[15]

The ACCC is of the view that a better approach than null undertakings is, firstly, to ensure that the declaration criteria are sound and, secondly, once a service is declared, to implement appropriate pricing structures and incentive mechanisms in accordance with the risks involved with the facility in question. The ACCC considers this is more desirable than the essentially arbitrary application of exemptions to facilities that are classified as providing "new services" and being "marginally profitable".

As an alternative to the declaration process, and in preference to access holidays, the ACCC considers that regulation should not apply to a project if the investor puts in place arrangements that seek to use competition to determine access prices. One such avenue is the use of competitive tendering. The National Third Party Access Code for Natural Gas Pipeline Systems (the Gas Code), for example, contains provisions for a "competitive tender process" (sections 3.21 to 3.36) to determine the tariffs for a new pipeline. Once the regulator approves a tender, the pipeline becomes a covered pipeline under the Code and the tariffs contained in the winning bid are deemed to be the reference tariffs applicable to the access arrangement. Those tariffs would not be reviewed by the regulator for the duration of the access arrangement period as determined by the tender process.

3.2.4 Undertakings for services covered by other access regimes

Section 7.3 of the Productivity Commission Position Paper considers the issue of whether an access provider should have the ability to choose between offering an undertaking under Part IIIA or being covered under a certified State/Territory regime, in particular an industry-specific regime. The Productivity Commission noted a number of possible disadvantages arising from the possibility of dual coverage; specifically, the possibility of "double regulation" and regulatory gaming. Indeed, the Productivity Commission extracts comments from three State governments strongly in favour of curtailing the possibility of dual coverage.

However, the Productivity Commission considers that Part IIIA should be the model for all access regimes. Indeed, it proposes that the possibility of dual coverage operate as a form of legislative pressure to align industry-based regimes with the national regime in Part IIIA.

The Productivity Commission recognises the need for flexibility to deal with the particular circumstances applying to individual industries. Indeed, after noting that, because of the

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[15] NECG, *Joint Industry Submission on the Productivity Commission's Review of the National Access Regime*, June 2001, p. 27.

different circumstances of particular infrastructure industries it would not be sensible to be overly prescriptive, it quotes from the submission of the New South Wales Government as follows:

> The system allows for regimes to be tailored to local conditions, whilst simultaneously operating in an overarching national framework, thereby enhancing efficiency and achieving better outcomes.[16]

The ACCC agrees that it is desirable to maintain flexibility to suit the particular needs of certain industries. One size does not fit all.

The ACCC considers that, in order for the potential for dual coverage to be an incentive for State and Territory access regimes to be aligned with Part IIIA, the undertaking provisions would need to be highly prescriptive. They would need to be so prescriptive that there was only one access model or pricing methodology that would be approved, or accepted, as an undertaking. While Part IIIA allows flexibility in regard to undertakings, it would be impossible for industry-specific access regimes to be designed to avoid the potential for industry participants to game the regulatory framework by offering an undertaking in slightly different terms.

By way of illustration, the National Third Party Access Code for Natural Gas Pipeline Systems currently requires an access provider to supply certain information to potential access seekers. This requirement is consistent with both the certification and the undertaking criteria. However, it is not necessary under either criterion. It would seem that there is at least potential for a pipeliner to submit an undertaking that did not have this requirement for information provision. Unless the undertaking provisions were prescriptive to the point of requiring the provision of such information, and this was also required in a similarly prescriptive certified regime, the opportunity for regulatory gaming would remain.

Another example arises in relation to pricing. Even if the Productivity Commission's proposed pricing principles were included in legislation, more than one pricing methodology would be consistent with those principles. It would therefore be possible for an access provider to offer an undertaking that was consistent with those principles and yet different from the pricing methodology adopted by a particular industry in a certified regime, thus again opening the opportunity for regulatory gaming.

The ACCC supports the retention in Part IIIA of the ability for industry-specific access regimes to be developed and certified, and the ability of access providers to offer individual access undertakings. However, it considers that if the legislation is to permit undertakings to be offered by access providers in an industry to which a certified regime applies, the legislation should specifically make provision for this. It should clarify whether there are any limits on the ability of access providers to offer undertakings. It should specify whether an undertaking and the provisions of a certified regime operate concurrently, or if one mechanism is to be given priority. There are also administrative issues that should be clarified; for instance, in the circumstances where there is concurrently an application for coverage of a facility by an access regime and an undertaking has been lodged for assessment, should both processes proceed simultaneously or should one await the outcome of the other?

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[16] See page 174.

3.3 Time limits

The Productivity Commission concludes[17] that the introduction of mandatory time limits for each step in the Part IIIA process would have a number of disadvantages. In particular, the Productivity Commission refers to the difficulty of imposing binding time limits on courts and the possibility that such time limits would compromise good decision-making in complex cases.

However, the Productivity Commission considers that indicative time limits may be of considerable value in imposing discipline upon the decision makers. In this context, comments are sought on target time limits suggested by the NCC.

The NCC suggested that a four month limit apply in relation to declaration applications and that a six month limit apply in relation to certification applications. The NCC proposes that such time limits apply both to the initial decision maker and to the Australian Competition Tribunal. The NCC also proposes that there be a mechanism to allow an extension in complex cases. There is no explanation of how an extension mechanism would operate, or what cases would qualify as complex.

The Productivity Commission seeks comments on whether such time limits should also be imposed in relation to the assessment of undertakings and to the making of arbitration determinations.

In any consideration of non-binding time limits it is important to understand the steps necessary in making the administrative decision. For instance, arbitrations will usually involve holding hearings and providing an opportunity for the parties to make written submissions on various matters. These matters may not always be clear at the outset of an arbitration. Consequently, arbitration of access disputes will usually involve parties being given a number of opportunities to make submissions. It is not always easy to predict how long this process will take and the timing is not always within the control of the regulator.

In relation to undertakings, the ACCC is required to publish the undertaking and invite submissions thereon.[18] In order that submissions received address the issues the ACCC perceives to be important, the ACCC has found that it is useful to also publish a discussion paper. In addition, the ACCC considers that the most effective way to comply with its obligation to provide procedural fairness is to publish a draft decision and seek further comments thereon. In making a decision it may also be necessary to obtain technical, economic, legal or other independent advice. It is difficult in the abstract to determine what a reasonable time limit would be for the completion of such a process. It depends upon the nature and complexity of the issues, including whether they have been considered previously. It would also be difficult to impose a threshold test requiring that a matter be "complex" before an extension would be permitted.

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17 Refer to section 9.3 of the Position Paper.
18 Refer to Section 44ZZA(4).

The ACCC reiterates that it would have concerns about the introduction of binding time limits. However, it notes that non-binding time limits are already part of the National Third Party Access Code for Natural Gas Pipeline Systems, including in relation to applications for coverage and the making of arbitration determinations. These operate in conjunction with clear provisions dealing with the extension of the relevant time limits. These extension provisions are not limited by the need to demonstrate any specific level of complexity.

While some access disputes or undertakings may raise simple matters that can be progressed quickly, the ACCC notes that they are more likely to raise complex and time-consuming issues such as those regarding appropriate pricing principles.

4. Pricing

4.1 Pricing principles

The Productivity Commission is recommending that specific pricing principles should be incorporated in Part IIIA of the Trade Practices Act. Four pricing principles have been developed to support the Productivity Commission's proposed objects clause, which states:

> The objective of this Part is to:
>
> (a) enhance overall economic efficiency by promoting efficient use of, and investment in, essential infrastructure services; and
>
> (b) provide a framework and guiding principles for industry-specific access regimes.

The Productivity Commission also concludes that there is a proliferation of approaches to access pricing. It argues that introducing clear pricing principles will have certain benefits, including:

- providing greater clarity to regulators when setting access prices in order to achieve consistent decision making;
- ensuring that regulators' decisions are consistent with the intent of the legislation;
- overcoming accusations that the views of the regulator will affect pricing outcomes in circumstances where the regulator is required to interpret vague and conflicting pricing criteria;
- giving greater certainty to regulated firms and access seekers in the negotiation-arbitration framework; and
- promoting convergence of pricing approaches in industry regimes.

The pricing principles proposed by the Productivity Commission are:

> Proposal 8.1 (Tier 1): The pricing principles in Part IIIA should specify that access prices should:
>
> - generate revenue across a facility's regulated services as a whole that is at least sufficient to meet the efficient long-run costs of providing access to these services, including a return on investment commensurate with the risks involved;
> - not be so far above costs as to detract significantly from efficient use of services and investment in related markets;
> - encourage multi-part tariffs and allow price discrimination when its aids efficiency; and
> - not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, unless the cost of providing access to other operators is higher.

The ACCC does not concede that it is necessary to include additional guidance in Part IIIA relating specifically to access pricing. Rather, access is about a large range of issues, only one of

which is the price of access. For instance, in addition to prices, the terms and conditions of access may also involve approaches to: new and replacement investment; quality of service; incentive mechanisms; information provision and disclosure; negotiation of connection agreements; structural and accounting separation; dispute resolution; and an enforcement mechanism. The ACCC believes that Part IIIA's existing decision criteria are sufficiently broad to deal with this whole range of access issues. The ACCC believes that introducing pricing specific principles would tend to over emphasise pricing issues at the expense of other, equally important, terms and conditions of access.

The ACCC is of the view that greater clarity for service providers and access seekers is already provided in the more detailed principles in industry-specify codes such as the Gas and Electricity Codes. The ACCC considers that incorporating pricing principles in documents such as these Codes is preferable to amending the legislation to include broad pricing principles. The Productivity Commission's "one size fits all" approach fails to recognise different market characteristics between industries that may justify departure from the pricing principles for a specific industry. The ACCC's submission in response to the Productivity Commission's draft report into the review of the Telecommunications Competition Regulation identifies problems with the proposed pricing principles that relate specifically to the telecommunications industry.

The Productivity Commission does not seem to have considered what practical impact incorporation of pricing principles in Part IIIA would have on the various industry codes currently in existence. In the short term, incorporation of broad principles is unlikely to have any impact on industries that are regulated under an industry-specific access code. The regulator's assessment of a proposed access arrangement/undertaking will still be undertaken in accordance with the more detailed pricing principles in the various codes. In the long term, however, once pricing principles are incorporated in Part IIIA, some industry participants may argue for the abolition of the codes (as some industry participants are now doing). In the event that the industry-specific codes are abolished, rather than leading to greater clarity and certainty, incorporation of broad pricing principles in Part IIIA will have the opposite effect.

The ACCC also questions whether such broad principles would achieve the Productivity Commission's stated objective of promoting convergence of pricing approaches across various access regimes, as the principles are so broad that any number of sub-sets of more detailed principles could fit within the parameters of the proposed broader principles.

Nevertheless, if the Productivity Commission maintains its position that it is a problem that Part IIIA does not contain detailed pricing principles, then the ACCC believes that the principles proposed in the Productivity Commission's Position Paper are not the answer. The ACCC believes that the meaning of the pricing principles are indiscernible unless they are read in conjunction with the analysis on pages 200 to 206 of the Position Paper. This is likely to be problematic because, if it was requested to do so, a court would not have the freedom to rely on a Productivity Commission report to interpret the meaning of the pricing principles. Consequently, the ACCC believes that the proposed principles are unlikely to assist in introducing greater clarity or certainty into the operation of Part IIIA. Indeed the Productivity Commission itself acknowledges the definitional difficulties of some of the terminology (for example, the Productivity Commission notes that the concept of "costs" has many dimensions).

In addition, the ACCC believes that the second of the Productivity Commission's principles is so loosely worded as to be almost meaningless.

From an examination of the analysis on pages 200-206 of the Position Paper, it would appear that the pricing principles propose that access prices be set:

- to limit monopoly profits;
- in the form of multi-part tariffs where:
  - the variable price is set equal to marginal costs;
  - an access charge is used to recover any revenue short fall and, to minimise distortions, and this access charge be unrelated to usage but could vary between users; and
- to eliminate cross-subsidies between a regulated activity and a vertically-related contestable activity.

If this is what the Productivity Commission intended the principles to mean, then the ACCC believes that the proposed principles are unexceptional and would tend to reflect the generally accepted economic principles related to the efficient pricing of infrastructure. Indeed, the ACCC does not believe that the addition of these principles would greatly alter recent efforts to improve the efficiency in the pricing of electricity and gas transmission networks. For instance, the ACCC's draft determination on the NEM's transmission and distribution network pricing, released in December 2000, already embodies these principles.

The ACCC also believes that, as these principles refer solely to efficiency objectives, they are simplistic and therein lies an additional danger in introducing them into Part IIIA.

The ACCC is also concerned that including pricing principles in Part IIIA that emphasise efficiency objectives alone would result in an abrupt change in the approach to setting access prices in some instances. The ACCC believes that it may be appropriate for there to be a transitional period in certain circumstances over which access prices are rebalanced to reflect a greater emphasis on efficient pricing as against uniform pricing.

Short run marginal cost pricing

The proposed pricing principles advocate the use of short run marginal cost (SRMC) pricing (in the context of multi-part tariffs). In the case of electricity networks, the SRMC prices consist largely of line losses and congestion, both of which will vary between connection points and at the same connection point over time.

Transmission prices in the NEM already embody SRMC prices to the extent that the differences in the price of electricity between the NEM regions (largely the participating States) already reflects losses and congestion. However, a significant remaining issue is the extent to which this regional pricing structure of the NEM should be applied to each of the connection points on a transmission network (ie, nodal pricing). Nodal pricing has been used in electricity markets in

New Zealand and in the United States of America (eg the Pennsylvania-New Jersey-Maryland market). In the Australian context, approaches to disaggregating the existing NEM regions are being canvassed by the National Electricity Code Administrator as part of its Review of Integrating the Energy Market and Network Services.

Being based on SRMCs, nodal pricing has the advantage of efficiently signalling the use of, and investment in, electricity transmission networks. However, nodal pricing has its detractors who argue that it is far too costly to administer a network pricing regime that delivers electricity at prices that vary across the NEM's 340 plus connection points on a half hourly basis. It is also argued that, under such a scenario, it would be very difficult for electricity traders to hedge their risks in an already thin financial market.

Clearly, there are competing views on the appropriate approach to electricity transmission pricing. Nevertheless, would the inclusion into Part IIIA of a principle of SRMC pricing require the ACCC to only accept amendments to the NEM Access Code that adopted, in full, a nodal pricing approach to electricity transmission networks?

Subsidy-free pricing

One of the primary objectives of an access regime is to address the problems associated with economies of scope. That is, to allow interconnection with, or use of, an existing facility without being required to duplicate that facility. However, the Position Paper only briefly describes the issues associated with economies of scope (eg, Box 3.2); it is barely mentioned elsewhere and it is not addressed in the Productivity Commission's discussion of access pricing principles.

In the case of an electricity network, which interconnects a number of generators with a number of loads, the delivery of electricity to customers at different locations and at different times can be viewed as different products or services. One might have expected that if the proposed pricing principles were to disallow cross subsidies between a regulated activity and a vertically-related contestable activity, then those same principles would also disallow cross-subsidies between horizontally related regulated services or products. That is, access prices charged at each connection point should be subsidy free. The standard approach to this problem would be to require an access price to sit somewhere between the directly attributable costs and the stand alone costs of providing a service (the remaining problem is to allocate the common costs between network users).

Clearly, including a "subsidy-free prices" principle in the Productivity Commission's recommendations would result in a symmetrical treatment of all of the services provided by the facility owner. However, the ACCC believes that a cautious approach should be taken if such a principle were to be included into Part IIIA, as it may lead to the unwinding of the uniform pricing approaches that have been employed by some of the facility owners. Any "quick fix" approach may lead to price shocks that may be socially disruptive and unsustainable.

4.2 Rates of return

In its discussions of the pricing principles, the Productivity Commission raises concerns that rates of return currently allowed by regulators, and which are designed to constrain monopoly

rents, may deter investment. The Productivity Commission notes the dissatisfaction of service providers with the regulators' rates of return, particularly in relation to risk. The Productivity Commission notes that the Capital Asset Pricing Model (CAPM) only caters for market (diversifiable) risk and does not include a component for specific (non-diversifiable) risk, particularly relevant if a service provider self-insures against this risk.

The Productivity Commission acknowledges that regulators do recognise that risks can vary from project to project. Nevertheless, in order to encourage new investment, the Productivity Commission is of the view that regulators should not be too zealous in their attempts to align revenue to costs and to constrain monopoly rents. The Productivity Commission is of the view that the longer-term benefits of consumers having continued access to existing infrastructure services and being able to benefit from new investment outweigh any overcompensation of the service provider in the short-term. According to the Productivity Commission, the short-term costs to consumers from high prices are likely to be less that the costs of access prices that are too low.

The ACCC is often criticised by certain sections of industry as being too consumer-focused with not enough regard to the interests of service providers. In its position paper the Productivity Commission quotes the Australian Pipeline Industry Association, which argues that the primary role of regulators is as "consumer advocates" and as such the objective of regulators is to ensure lower tariffs for customers, with little or no regard to the long term development needs of energy infrastructure such as gas transmission pipelines.

The ACCC does not support the view that regulated rates of returns are deterring investment, and that regulators are consumer-focused and ignoring the interest of service providers. Over all the industries the ACCC regulates the objectives are similar. They are to develop a regulatory process which reduces monopoly pricing, provides a fair risk-adjusted return to service providers, and creates incentives for managers to pursue ongoing efficiency gains through cost reductions. As regulator, the ACCC aims to achieve a balance between the service provider receiving a fair return that will encourage appropriate new investment in the industry, and producing efficient tariffs that allow users to compete and invest in other markets.

Rate of return comparisons

Arguments that the rates of return allowed by regulators are too low to encourage new investment seem to be based on opinions rather than empirical evidence. National Economic Research Associates (n/e/r/a) recently undertook a study of regulated rates of return in the gas and electricity transmission and distribution industries in North America and the United Kingdom compared with rates of return in Australia. n/e/r/a found that the average real vanilla weighted average cost of capital (WACC) in Australia was 6.8 per cent compared with 6.6 and 5.6 per cent in North America and the United Kingdom respectively. n/e/r/a concluded that:

> … Australian regulators are, if anything, declaring higher vanilla post tax WACCs than in other jurisdictions examined. Purely based on the declared returns examined in this survey, Australian regulators

> appear to offer approximately the same or higher returns than North American regulators who in turn appear to offer significantly higher rates of return than in the United Kingdom.[19]

n/e/r/a went on to say:

> … it would appear that a strong case can be made from the statistics in this survey for the view that Australian energy regulators are providing incentives to invest that are at least commensurate with those offered in North America and the United Kingdom.[20]

n/e/r/a did acknowledge, however, the difficulties in drawing definitive conclusions from international comparisons of this type.

Recent ACCC decisions on rates of return also compare favourably to stock market returns (11.3 per cent over the past ten years) and average returns on Australian superannuation funds (10.3 per cent over the past three years), as shown in the table below.

Rather than setting rates of return that are so low as to act as a disincentive to investment, the ACCC considers that the rates of return approved in recent regulatory decisions are at the top end of what might be considered a reasonable range. In this sense the ACCC is satisfying the Productivity Commission's proposed Pricing Principle 2 that tariffs are set so that revenue does exceed costs (including a return on investment) to some extent.

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[19] n/e/r/a, *International Comparison of Utilities' Regulated Post Tax Rates of Return in: North America, The UK, and Australia,* March 2001, p. 2.

[20] n/e/r/a, *International Comparison of Utilities' Regulated Post Tax Rates of Return in: North America, The UK, and Australia,* March 2001, p. 2.

Table: Return on equity (post tax nominal) comparisons

	Facility	%
ACCC Final Decision, Oct-98	Victorian gas transmission pipeline systems	13.2
ACCC Final Decision, Jan-00	NSW & ACT electricity transmission (Transgrid & EnergyAustralia)	13.9
ACCC Final Decision, Jun-00	APT – Central West Pipeline	15.4
ACCC Draft Decision, Aug-00	Epic Energy – Moomba-Adelaide Pipeline System	13.0
ACCC Draft Decision, Dec-00	EAPL – Moomba-Sydney Pipeline System	13.0
ACCC Final Decision, Feb-01	SMHEA transmission (Snowy Mtns Hydro-Electric Authority)	11.2
ACCC Draft Decision, May-01	NT Gas – Amadeus Basin to Darwin	12.0
Australia – Super funds (Mercer survey)	Pooled superannuation funds – 3 year average return	10.4
Australian Stock Exchange (ASX Fact Book 1999)	Stock market 10 year average ROE – June 1988 to June 1998, (All Ords)	11.3

Note: The rates of return in this table are nominal rates, whereas the rates of return contained in the n/e/r/a report are real rates.

New facilities

As noted above, the Productivity Commission acknowledges that regulators do take account of varying risks among different projects. A practical example is the ACCC's decision on the Central West Pipeline in NSW, for which the ACCC approved a post-tax nominal return of equity of 15.4 per cent.[21] For existing pipelines the corresponding returns on equity have been around 12-13 per cent.[22] In the Central West Pipeline decision the ACCC recognised that as a greenfields pipeline it had greater risks than an established pipeline and this higher risk is reflected in the rate of return.

A crucial factor concerning regulated rates of return is that the *ex post* rate of return could vary significantly from the regulated *ex ante* rate of return. The Productivity Commission

[21] ACCC, *Final Decision, Access Arrangement by AGL Pipelines (NSW) Pty Ltd for the Central West Pipeline,* 30 June 2000, pp. 47-48

[22] See, for example, ACCC, *Draft Decision, Access Arrangement proposed by NT Gas Pty Ltd for the Amadeus Basin to Darwin Pipeline,* 2 May 2001, pp. 70-71, *Draft Decision, Access Arrangement proposed by Epic Energy South Australia Pty Ltd for the Moomba to Adelaide Pipeline System,* 16 August 2000, pp. 73-74, and *Draft Decision, Access Arrangement by East Australian Pipeline Limited for the Moomba to Sydney Pipeline System,* 30 June 2000, pp.80-82.

acknowledges this and in this regard draws heavily on the submission made by Professor Stephen King. In his submission, Professor King expressed concern that parties will only seek access to a new facility when they can observe how successful the project is. New entrants will seek access to the facility only if the project is successful which in turn will erode the total profits of the owner of the facility. Professor King concludes that under these circumstances the *ex post* rate of return of the owner of the facility will be less than the *ex ante* rate of return.[23]

A distinction should be drawn between returns to the facility owner and those to firms in the contestable downstream market. The type of access arrangement in place is also crucial, particularly if the access arrangement includes an incentive mechanism, such as advocated in the Gas Code, that would allow the facility owner to retain additional revenue if forecasts are outperformed. Under these circumstances, while the entry of new players may result in reduced profits in the contestable downstream market, the same cannot be said for the returns to the facility owner. Indeed, the reverse is true. Tariffs for a facility are typically based on expected volumes and part of the incentive mechanism to facility owners is that they will retain any excess revenue if actual volumes exceed forecasts (at least for the duration of the regulatory period, but often carrying over into the next period). Likewise, if actual volumes are below forecasts, the facility owner will wear the loss. Accordingly, it is in the interests of the facility owner, who should be indifferent to returns in the contestable downstream market, to encourage third party access to maximise usage of the facility. Under these circumstances, the *ex post* rate of return will **exceed** the *ex ante* rate of return.

To illustrate his point Professor King provides a simple example in which a new “marginal” project costing $51m will yield revenue of $100m if successful, $60m if moderately successful, and only $20m if unsuccessful. The probabilities of these three scenarios occurring are 25, 50 and 25 per cent respectively. In an unregulated environment the service provider is free to set the price and would charge a relatively high price if the project is successful and a low price if unsuccessful. The expected revenue is $60m based on the above probabilities and the expected profit is $9m.

Professor King then examines the situation in the case of regulation. He argues that if the project is successful the service provider would only receive a return of $60m, rather than the $100m received in an unregulated environment. In this case the expected revenue is $50m with a corresponding loss of $1m. Therefore, in a regulatory environment the project would not proceed.

In the case of a strict “cost of service” or rate of return approach to price setting, in which tariffs are adjusted for differences between forecast and actual volumes, Professor King’s argument has some validity in that regulation will reduce excessive returns. However, the same principle applies if less than normal returns are earned, in which case regulated prices will increase.[24]

The situation is different in the case of a regulatory approach that includes an incentive mechanism, rather than a strict cost of service approach. Under an incentive mechanism

[23] Stephen P. King, *Access – what where and how,* pp. 12-15

[24] Regulated prices are maximum prices. In the example presented by Professor King, if the project is unsuccessful the service provider may not be able to achieve the regulated price.

approach prices would not be adjusted for differences between forecast and actual volumes. Under Professor King's example, if the project is successful, the service provider will receive revenue in excess of $60m and a return in excess of the "normal" $9m. Under this scenario, however, the service provider may not be able to fully achieve the target revenue of $100m, since it is prevented from increasing prices above the regulated price.

In the type of scenario presented by Professor King, the "marginal" investment would proceed in the absence of regulation, but not under regulation. Regulated prices set a maximum price which the service provider cannot exceed if the project is successful. However, if the project is unsuccessful, the service provider may have to set prices below the regulated price. In other words, the service provider shares some of the gains if the project is successful, but bears the risk if the project is unsuccessful. In this scenario a marginal project may have a normal *ex ante* return without regulation, but a below normal *ex ante* return with regulation. This is not to say, however, that regulatory instruments are inadequate for dealing with new projects, even those at the margin.

As mentioned above in the case of the Central West Pipeline, the ACCC acknowledged the higher risks associated with a greenfields project by approving a higher rate of return. It is important to note, however, that not all risk can be accounted for in the rate of return. The Capital Asset Pricing Model (CAPM) approach, often used by service providers as the basis for the rate of return, includes a premium for market risk only, not specific risk, which can be provided for in the cash flows (as an insurance premium or by a probabilistic assessment of cash flows), or by faster depreciation to deal with the risk of stranding.

Another feature of the Central West Pipeline decision was an initial regulatory period of ten years, in contrast with the more usual period of five years for established pipelines. Accordingly, in the event that actual volumes exceed forecasts, the service provider will be able to achieve a greater revenue stream than was forecast for an extended period.

A competitive tender process is an alternative instrument for establishing the level and structure of prices for new facilities (see, for example, sections 3.21 to 3.36 of the Gas Code). In the ACCC's view, the Productivity Commission's report fails to adequately acknowledge the range of instruments, in addition to a premium built into the rate of return, available for dealing with risk and new facilities.

Apart from the fact that the rationale for Pricing Principle 2 is without foundation, there would be problems in implementing the principle in practice. A concern with the proposed amendment as it stands is how far above costs tariffs should be to encourage new investment and, at the same time, not detract significantly from the efficient use of facilities. Rather than resolve the differences between regulators and service providers and provide greater certainty, it may merely add another level of complexity as the regulator and service provider debate not only the level of efficient costs, but also the extent to which revenue requirements should exceed costs.

The Productivity Commission acknowledges the practical difficulties of this principle and, perhaps in recognition of the complexities of implementing this principle, the Productivity Commission then advocates an alternative mechanism for dealing with the issue of regulation

supposedly discouraging new investment. The Productivity Commission's proposal is the use of "access holidays" for marginal new facilities. In other words, the particular facility would not be subject to regulation for a certain period of time. The use of access holidays for marginal investments is also proposed by Professor King. Theoretically, the concept of an access holiday for marginal new investment has some appeal. If a new facility, unregulated, can earn a rate of return no higher than that which would apply under regulation, there is little reason to regulate – the costs of regulation would outweigh the benefits. In practice, however, there are many issues that need to be addressed, such as determining which new facilities are "marginal", the duration of the holiday, and the regulation regime to apply after the holiday. (The issue of access holidays is discussed in more detail earlier in this response.)

4.3 Asset valuation

The Productivity Commission's discussion of the Part IIIA pricing principles also discusses some of the arguments about the relative merits of the various asset valuation techniques. The Productivity Commission is seeking further information and participant views on the advantages and disadvantages of the key methodologies for valuing infrastructure assets.

The Productivity Commission questioned the use of the Optimised Depreciated Replacement Cost (ODRC) as a regulatory tool and suggested that historical cost valuations may be a sound starting point, particularly for industries with relatively stable costs.

Rather than being the regulator's tool of choice, the ODRC asset valuation methodology has largely become the technique of choice by the government owners of the assets. This preference stems back to the "red book"[25] which was published by a committee comprising the representatives from the Commonwealth, State and Territory governments and chaired by the Productivity Commission's predecessor, the Industry Commission. The ODRC methodology is seen as a pragmatic alternative to the "red book"s preferred use of deprival valuation. For instance, for regulatory purposes deprival valuation contains the circularity that the revenue of the business should be set with reference to asset values which are in turn determined in accordance with the expected future economic benefits generated by the assets. The ODRC methodology breaks this circularity.

Given the findings of that report, many of the government businesses were subsequently restructured, corporatised or privatised on the basis of deprival or other similar valuations. Corporate structures and balance sheets were then established on the basis of these asset valuations. Consequently, in the case of electricity, a pre-condition for national transmission regulation was for these asset values to be protected, at least for the initial regulatory review period.

Even given this history, the ODRC asset valuation technique has a number of desirable efficiency characteristics. The ODRC valuation methodology ensures there is an equivalence between the value of existing assets and the value of replacement assets. Consequently, prices

[25] Steering Committee on National Performance Monitoring of Government Trading Enterprises 1994, *Guidelines on accounting policy for valuation of assets of government trading enterprises: using current valuation methods*, Industry Commission, Melbourne, October.

based on these asset values should provide the correct incentives for the use of a network and for new investment in that network. Conversely, if a business values its assets on a historical basis and those assets are nearly fully depreciated, then access prices and revenues based on those asset values would be very low. The business would then have an incentive to invest in replacement assets in order to raise their revenues and may even over invest in additional capacity because of the high demand stimulated by the low prices. As a consequence, prices could jump once revenues are determined on the new asset values, and it is even possible that fully depreciated assets could be replaced, even though they may still have a substantial remaining economic life.

Despite these desirable efficiency characteristics, a number of interested parties have expressed concerns about using ODRC. Some argue that ODRC will lead to increases in asset values thereby providing the regulated business with an additional return over and above that provided for in a regulatory decision. For example, it is argued that government businesses may have paid only limited compensation for non-depreciable assets, such as easements for gas or electricity networks, yet an ODRC valuation could run into some hundreds of millions of dollars (taking into account urban land values and land planning requirements).

However, in its Draft Statement of Principles for the Regulation of Transmission Revenue, the ACCC has proposed using depreciation to address these concerns. For instance, the ACCC proposed the concept of negative depreciation to take account of an appreciation in easement values. In effect, this approach would require the regulated business to forego current income in order to "purchase" the increase in easement value. The business would then be able to earn a higher future revenue stream consistent with the higher asset value.

A further issue in relation to ODRC concerns the derivation of ODRC from optimised replacement costs (ORC), which is currently the subject of considerable debate. The more traditional approach is that ODRC should reflect historical effects, while an alternative view has been proposed by Agility Management Pty Ltd. Agility's approach is forward-looking and results in a different value of ODRC to values reflecting past depreciation.

It is also noteworthy that different industry codes adopt different approaches to the issue of asset valuation. The Gas Code provides that the value of the initial capital base should not normally fall outside the range of ODRC and depreciated actual (historical) costs. The Gas Code also specifies several other factors that the regulator should take into account in determining the value of the initial capital base. Once established, the capital base cannot be revalued at a later date in line with current technology. On the other hand, the Electricity Code does not have this restriction and ODRC would have on-going relevance in this case.

The ACCC considers that the issue of asset valuation is more appropriately dealt with in the various industry codes, rather than as a legislative change to Part IIIA.

4.4 Pricing conclusions

The ACCC sees little value in incorporating broad pricing principles in Part IIIA. It is of the view that broad principles such as those proposed by the Productivity Commission do not achieve the Productivity Commission's stated objectives of enhancing clarity and certainty, or of providing consistency across various regimes.

Rather than including broad principles in Part IIIA, more detailed pricing principles can be more easily and directly dealt with in industry-specific regimes such as the Gas and Electricity Codes. In this manner pricing principles have been developed which suit the characteristics of the industry concerned, which can address all of the issues associated with access and not simply focus on prices. The ACCC is of the view that such an approach leads to greater clarity and certainty than the Productivity Commission's proposal.

The ACCC also has concerns with some of the details of the pricing principles, which seem to be based on the presupposition that current regulated returns are deterring investment in new infrastructure. The ACCC disagrees with this view which it considers is not supported by empirical evidence.

5. The overlap of Part IIIA and Parts IV and VII

The Productivity Commission expressed concern that access arrangements sanctioned under Part IIIA did not shield access providers and access seekers from action under provisions of Part IV of the Act.[26] A number of submissions referred to this aspect of the national access regime as creating some investor uncertainty.

The Productivity Commission recognised that the terms and conditions upon which access is supplied may themselves raise competition issues. For instance, they may limit the opportunity for subsequent new entrants to obtain access to the facility. However, the Productivity Commission considered that the additional costs, both direct (in the form of additional compliance costs), and indirect (as a consequence of uncertainty) outweigh the risk of access terms and conditions being anti-competitive.

The Position Paper uses a quote from the Hilmer Committee Report to assert that it was the intention that the national access regime provide protection against claims under section 46. However, the quote refers only to the existence of a declaration excluding claims under section 46 to the extent that those claims relate to allegations of refusing to provide access to the declared facility. However, an access provider may use its market power in contravention of section 46 notwithstanding that access is being provided. Because the granting of access is intertwined with the agreement of terms and conditions, it is difficult to justify even the limited type of exemption envisaged by the Hilmer Committee in relation to section 46. The ACCC notes that because section 46 involves conduct with a proscribed purpose it is not possible to authorise such conduct; nor should it be. Consequently such a blanket exemption would not be justified.

While the concepts of access and competition are related they are not equivalent. It is possible for access to be provided upon terms and conditions which are anti-competitive.

The ACCC regards it as essential that it has the ability to scrutinise access arrangements to determine whether they are anti-competitive. It will be possible in some circumstances to determine this at the time the access arrangements are accepted or determined. However, this will not always be the case. Where it is not, the ACCC considers that the existing overlap between Part IIIA and Parts IV and VII is appropriate.

The ACCC can presently take into account any anti-competitive effects of access arrangements when considering whether such arrangements are in the public interest. However, it would be possible to make this assessment more transparent by specifically referring to the potential anti-competitive effects of an arrangement as one matter that is to be considered under the rubric of public interest.

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[26] See section 10.3 of the Position Paper.

The Productivity Commission recommends that where a regulator is involved in setting the terms and conditions of access an automatic exemption from exposure to Parts IV and VII apply. In particular, the Productivity Commission proposes to exempt the following access arrangements:

(i) arbitrated determinations;

(ii) agreements negotiated under accepted undertakings;

(iii) registered private contracts; and

(iv) agreements reached under certified regimes with the involvement of the relevant regulator.

Consistent with the principles noted above, the ACCC does not oppose amendments that would offer access providers and access seekers limited protection from Part IV in relation to the first three categories of arrangements noted above. However, it would oppose offering such protection in relation to the last category; that is, agreements reached under certified regimes with the involvement of the relevant regulator. The ACCC is the statutory body charged with enforcement of Part IV of the Trade Practices Act and it would not be appropriate for regulators other than the ACCC to have the power to provide such protections to access providers and access seekers.

The ACCC notes that the Productivity Commission accepts that such exemptions should extend only to the terms and conditions established by the particular access framework. Other contract conditions would not receive such protection. This express limitation is essential. For instance, an undertaking may require parties to negotiate terms and conditions. The negotiated terms and conditions may themselves pose competition issues. It must only be the terms and conditions that are included in the access arrangements, that are therefore known to the ACCC at the time the arrangements are approved, that should attract protection. For instance, an undertaking may require an access provider and access seeker to agree on the times by which access will be provided to a railway. It is conceivable that the times agreed may raise competition issues if they impact upon the ability of potential new entrants to subsequently gain access to the facility.