AusCID Submission to the Productivity Commission in Response to the Position Paper on the Review of the National Access Regime

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Draft AusCID Submission to the Productivity Commission in Response to its Review of the National Access Regime

1. Overview

1.1 Introduction

The Australian Council for Infrastructure Development ("**AusCID**") welcomes the Position Paper which has been issued by the Productivity Commission ("**Commission**") in the course of its Review of the National Access Regime. In December 2000 AusCID made a submission ("**December Submission**") to the Commission in response to the Commission's Issues Paper[1]. This further submission is provided in response to the Position Paper and provides comment on certain specific issues arising from the Tier 1 and Tier 2 recommendations which have been made by the Commission. In doing so, it speaks on behalf of the AusCID membership. The members of AusCID were detailed in AusCID's December Submission and include major infrastructure owners, investors in major infrastructure, and those who are involved in operating, building, financing, designing and providing advisory services to providers of major infrastructure in Australia.

The current series of reviews[2] being conducted by the Commission is critical to the development of a coherent framework for regulation of natural monopoly infrastructure in circumstances where there is a significant risk of the exercise of market power. At present, there is a myriad of regulatory schemes which do not operate from a common set of objectives, have different criteria to trigger regulation, and have different approaches to setting the terms and conditions of access. Whilst there are some issues which need to be addressed in an industry specific context, AusCID is strongly committed to an overarching framework, such as that provided by Part IIIA of the *Trade Practices Act 1974* ("**Act**"), to operate as a model for the convergence of the existing regulatory schemes. This submission reflects AusCID's views on the role and scope of Part IIIA in that context.

The way in which access regulation has operated to date in Australia has caused significant concern amongst owners of and investors in infrastructure[3]. These concerns are very real and

[1] Productivity Commission, 2000, *Review of the National Access Regime*, Issues Paper, Canberra, October 2000

[2] Review of the National Access Regime, Review of Telecommunications Specific Competition Regulation, Review of the Prices Surveillance Act, 1983, Review of Price Regulation of Airport Services

[3] Position Paper pp63-65

are not complaints about the absence of monopoly rents. They reflect real concerns about the nature of investment risk in Australia. Already there have been several instances of delayed or abandoned investment. If this continues, whilst many of the resulting problems may not be evident in the short term, they will arise in the medium term and, as the Commission documented, the consequences of under-investment are severe. Unless better mechanisms are devised to provide certainty about the scope of infrastructure subject to regulation, and unless more appropriate regulatory parameters for the terms and conditions of access are established, there will be significant adverse effects for the Australian economy in the medium and long term.

Broadly speaking, AusCID considers that the criteria for declaration under Part IIIA provide appropriate touchstones for determining when regulation should apply. Over-inclusive regulation tends to arise more in the context of industry specific regulation than in the context of Part IIIA of the Act. This is an important reason why Part IIIA should be used as a framework against which other industry specific access regulation should be tested. AusCID has particular concerns about the way in which, following their inclusion in the regulatory scheme, whether by declaration or otherwise[4], the terms and conditions (both price and non-price) have been set by regulators. These concerns relate to the methodologies used, inappropriate recognition of capital requirements, and the overall level of permissible access charges.

To address these concerns AusCID :

- supports the Commission in seeking to limit the discretion provided to the regulator;
- supports the introduction of an objects clause in Part IIIA;
- suggests the introduction of a mechanism for testing if a natural monopoly service falls with the scope of access regulation; and
- recommends the introduction of a pre-investment framework undertaking which would provide a mechanism for agreeing with the Australian Competition and Consumer Commission the parameters for the terms and conditions of access under a regulated scenario post-construction;

[4] For example, under the mechanisms set out in the *Airports Act, 1996*

- supports the introduction of pricing principles into Part IIIA of the Act.

1.2 Executive Summary

Infrastructure lies at the heart of the Australian economy. The size and dispersed population of Australia makes proper investment in infrastructure in this country more important than in many other places in the world. Australia is at a critical stage in the development of its infrastructure with many potential projects under consideration. These projects involve both substantial capital upgrades to add to the range of services which existing infrastructure provides and new infrastructure. It is imperative that Australia's regulatory environment provide appropriate signalling to ensure this investment occurs and occurs in a timely fashion. AusCID is concerned that the current industry specific and generic access regimes are highly prescriptive and intrusive and are not consistent with incentive regulation or productivity improvements in infrastructure development. The current regime provides an excessive focus on short term consumer cost savings without proper regard to the adequacy of investment and the costs that will have in the long term.

The Commission's Position Paper is important in recognising these critical issues. The introduction of an objects clause which clarifies the role of efficiency in the interpretation of Part IIIA would be an important step in providing a focus to and a guiding objective for the interpretation of Part IIIA.

AusCID endorses the Commission's view that Part IIIA has an important role to play as the framework for industry specific regulation. Many of the regulatory problems which have arisen relate to industry specific schemes, such as the Gas Code and the Telecommunications Access Regime, which are more prescriptive than the approach outlined in Part IIIA. AusCID supports the requirement for certification of Commonwealth access regimes.

Perhaps most importantly in the context of future investment decisions, the current regime does not provide any adequate mechanism for infrastructure owners to know whether a particular investment will be subject to the regulatory regime and does not provide a suitable mechanism for setting a binding framework for terms and conditions of access once the infrastructure has been constructed.

To address these issues, AusCID proposes:

- the introduction of a binding advisory opinion to determine whether or not prospective investment would satisfy the criteria for declaration;
- the use of a framework undertaking by which the parameters for the terms and conditions of access under a regulated scenario would be agreed with the Australian

Competition and Consumer Commission prior to the investment being made. This would necessitate the framework undertaking being properly a framework undertaking and not constituting a detailed contractual arrangement. It would have the benefit of addressing issues at the time the investment was being made rather than *ex post* assessments of profitability which fail to take adequate account of the risks taken in the decision to invest.

The AusCID membership welcomes the Commission's Position Paper and would like to see increased attention in its final report on mechanisms to provide increased certainty on the terms and conditions of access arrangements.

1.3 Structure of the Submission

This submission addresses these issues. It is divided into five principal sections:

- Section 1, which contains introductory material;
- Section 2, which examines the policy issues underlying an appropriate balancing of infrastructure regulation, the role of access regulation in the context of broader competition policy issues and the role of Part IIIA in the context of generic and industry specific access regulation;
- Section 3, which explores the appropriate scope of coverage;
- Section 4, which identifies a range of mechanisms that could be employed to provide appropriate safe harbours for new investment;
- Section 5, which analyses the Commission's Tier One and Tier Two proposals to amend the declaration criteria;
- Section 6, which considers how the pricing principles recommendations will work in practice and makes some suggestions for additional pricing principles.

2. Critical Issues in Infrastructure Investment

2.1 The Rationale for Access Regulation

In the Position Paper, the Commission notes that *"in assessing the case for any regulation, the costs of intervention itself are an important consideration. Even if a regulation will provide*

benefits, intervention will only be warranted if those benefits exceed the regulatory costs."[5] This proposition should be the fundamental touchstone not only for deciding whether regulation is warranted but also for determining the nature of the regulation which is appropriate. In this sense, in the context of the Commission's review, the assessment of the costs and benefits is a two stage process. First one asks: is any regulation warranted? If so, then one must ask: what is the appropriate structure and content of that regulation given the costs and benefits which are associated with alternate models of regulation, which could be used?

The importance of the second cost/benefit analysis lies in the fact that recognition that some regulation is warranted should not necessarily lead to the imposition of a highly intrusive and costly regulatory environment. The extent of the regulation which is required and the structure of that regulation should be directly referrable to the extent of the "*natural monopoly problem*" which exists. This is consistent with the model of "*minimum effective regulation*" referred to in the Office of Regulation Review's Regulation Guide which states that, "*regulation should not only be effective, but should also be the most efficient means for achieving relevant policy objectives*".[6]

In AusCID's submission, proportionality between the extent of the access problem and the regulatory methods which are used to address that problem, is fundamental to a workable regulatory environment. In setting the terms and conditions of access under industry specific and generic access regimes, highly prescriptive and intrusive methodologies have been used by the Australian Competition and Consumer Commission ("**ACCC**"), which are not consistent with incentive regulation or productivity improvements. This approach to the terms and conditions of access has led infrastructure owners to focus attention on staying outside the scope of any form of regulatory intervention. Hence much of the debate in this review has been about the declaration and coverage criteria under Parts IIIA and XIC of the Act and the National Third Party Access Code for Gas Pipeline Systems (**"Gas Code"**) rather than about the principles for determining terms and conditions of access. Whilst it is fundamentally important that the hurdle to be satisfied before infrastructure is subject to access regulation is sufficiently high so as not to lead to inappropriate coverage, the detail of the terms and conditions of access will be the actual key determining feature of incentives in many cases. If

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[5] Productivity Commission 2001, *Review of the National Access Regime*, Position Paper, Canberra, March (**"Position Paper"**) at p.53

[6] That Guide identifies factors relevant to choosing the best regulatory form to address specific problems as including: the extent of the risk; the severity of the problem; the nature of the industry concerned; the need for flexibility or certainty in regulatory arrangements, and the availability of resources.

the arrangements which applied to regulated services or infrastructure were not as access seeker focussed as they are at present, the debate would focus more logically on the regulatory mechanisms which are appropriate, and the principles which enable an efficient determination of terms and conditions of access. AusCID considers that it is fundamentally important that the Commission give adequate attention to the consequences of regulation under the current regime and that undue attention not be paid to issues which, whilst important, are not the critical issues affecting infrastructure owners moving forward.

2.2 The Role of An Objects Clause

AusCID supports the inclusion of an objects clause in Part IIIA of the Act. In all of the decided cases under Part IIIA, resort has been had to extrinsic material to assist in interpretation. This has arisen because the Court or Tribunal has been seeking clarification of the purpose of the Part to assist in determining which of several alternate interpretations is consistent with the policy intent. It is only to a very limited extent that the Explanatory Memorandum and the Second Reading Speech for the Competition Policy Reform Act provide any guidance which assists in interpretation. As a result, resort has been had, in several instances, to the Hilmer Report. However, the Hilmer Report necessarily cannot be a reliable guide for ascertaining policy intent as a number of its recommendations in relation to access arrangements were not adopted. Therefore, as a mechanism to provide clarity in policy intent, an objects clause would be valuable. AusCID believes that even greater utility would be derived if the objects clause were not simply an underlying statement of policy intent to which resort could be had in cases of ambiguity, but also something to which the relevant decision maker, the National Competition Council (**"Council"**), the designated Minister, or the ACCC in its arbitration role, must have regard in applying the criteria.

AusCID sees particular value in this approach because this area involves complex issues of economic regulation where, absent clear identification of legislative purpose, there is significant scope for regulatory discretion to be exercised in ways which are not consistent with the original legislative intent. Whilst a number of the Commission's other recommendations would limit the extent of the discretion which otherwise exists, a material level of discretion will remain. Guidance could usefully be provided as to the exercise of these remaining discretions in an objects clause.

Efficiency objectives are important not only in the declaration process but also in each stage relevant to the determination of terms and conditions of access, i.e., consideration of the terms of any access undertaking, the principles to be applied in the resolution of any arbitration, the certification process for an access regime and the acceptance of any industry code. The

objects clause should guide each step. Whilst detailed pricing principles can be addressed at the operational level of Part IIIA[7], the overall objectives of the Part should be used in applying those principles. AusCID sees no reason of policy or practicality which would limit the application of the objects clause to the declaration criteria.

AusCID supports the objects clause proposed by the Commission.

2.3 Part IIIA as an Architectural Framework for Access Regulation

In Box 2.6 and Appendix B of the Position Paper, the Commission details the various industry specific access regimes which are in place. The divergence between regimes is well illustrated in those summaries. AusCID recognises the role that industry specific regulation can have and that as between different types of infrastructure the "*one size fits all*" approach will not be appropriate, particularly in determining terms and conditions. However, there is no virtue, and considerable cost, in difference without a material reason for that difference. In many of the current industry specific regimes the reason for the differing approaches taken is not clear from the legislation , the explanatory material or any inherent features of the industry .

AusCID supports the Commission's finding that:

The current approach of a national access regime operating in tandem with, and providing guidance for, industry-specific regimes has significant advantages. In effect, it draws on the strengths of both the generic and specific approaches, while avoiding some of the pitfalls of a uni-dimensional solution…Moreover, underlying the various arrangements should be the general principle that Part IIIA and industry regimes diverge only where specific circumstances make this absolutely necessary[8].

In this regard, AusCID considers that the Commission's proposal for certification of Commonwealth access regimes would be useful in seeking to achieve increased convergence. Whilst there will be no sanction which would arise from the Commonwealth seeking to introduce a more prescriptive regulatory scheme, AusCID believes that the process itself will be valuable and focus attention on the benefits of moving to common regulatory principles across industries.

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[7] Position Paper at p104

[8] Position Paper at p93

2.4 Some Evidence on the Costs of Regulation

This part seeks to provide the Commission with some analysis of the types of costs which arise in access regulation and takes up the Commission's invitation to "*provide specific examples of the impacts of access regulation on investment in essential infrastructure*"[9].

AusCID considers that the Commission has correctly identified the types of costs which can arise from regulation. They are:

- reduced incentives to invest in infrastructure facilities;
- inefficient investment in related markets;
- constraints on the scope for infrastructure providers to deliver and price services efficiently;
- administrative and compliance costs;
- wasteful strategic behaviour.

There are a number of instances of this arising. Whilst some do not arise specifically under Part IIIA of the Act, they are nonetheless issues with access or price regulation of natural monopoly infrastructure and are therefore referred to in this submission.

(a) Melbourne Ports Corporation

Melbourne Ports Corporation has been planning to build a third container terminal and expand railway infrastructure as part of its expansion of the facilities at the Port of Melbourne. The activities of Melbourne Ports Corporation are regulated by the Office of the Regulator General ("**ORG**") in Victoria and it subject to an average revenue cap. The way in which the ORG has dealt with these issues causes significant concern.

In its five yearly review of port charges, Melbourne Ports Corporation sought to recover the investment in the railway through an increased charge, this was disallowed by the ORG because it was determined not to relate to the provision of prescribed services. However, such expenditure had historically been funded by way of wharfage charges. In its final decision, the ORG expanded its definition of "*prescribed services*" for some services, but did not approve the rail investment. Even if this decision arose from a strict legal interpretation of *"prescribed*

[9] Position Paper at p65

services" it highlights the problems which arise from explicitly over prescriptive regulation which fails to have proper regard to the historical structure of charges and which does not have mechanisms available to ensure adequate ongoing investment in infrastructure. "*The consequences of the ORG disallowing this expenditure are that the Melbourne Ports Corporation will not be able to generate revenue to enable the funding of an appropriate financial return on this proposed expenditure*."[10]

The container terminal was planned by Melbourne Ports Corporation to be developed in year 4 or 5 of the price cap. Because of the lack of specificity about costing, the fact that the planned development would not occur for 4-5 years, potential private sector involvement in the project and the fact that the development had the potential to significantly increase the Melbourne Ports Corporation's required revenue and therefore prices to port users, it was considered that it would be inappropriate to increase significantly revenue earned from port users where the Melbourne Ports Corporation could not be reasonably certain that there would be a corresponding benefit. It therefore did not include the investment plans for the container terminal in its submission to the ORG. but it asked for the next price review to be brought forward, to deal with this investment. This was denied by the ORG.

This decision has led Melbourne Ports Corporation to comment as follows:

> "*The Melbourne Ports Corporation considers that the capital projects which were excluded from its pricing submission, will be required to be undertaken in the future in order to ensure that the port is able to meet forecast demand for facilities as a result of trade growth. However, as the timing and magnitude of such projects becomes clearer, the consequence of the ORG's decision may be a deferral of expenditure which should otherwise be undertaken from an operational perspective. Such a deferral would have an adverse impact on the efficiency of the Port of Melbourne and may lead to a loss of trade to other ports*."[11]

(b) Perth Airport

Perth Airport applied to have its investment in a covering for its second runway approved by the ACCC under the Necessary New Investment ("**NNI**") rules, as required under the *Airports Act 1996*. The ACCC considered that the covering was not "*new investment*" and thus not covered under NNI provisions. The basis on which it did so demonstrates the problems which

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[10] Melbourne Ports Corporation submission to ESC Review, p10

[11] Melbourne Ports Corporation submission to Essential Services Commission Review, p10-12

arise from the way in which broad discretions can be applied by regulators. In its Final Decision[12] the ACCC adopted an appropriate definition of *"new investment*" namely "*a change in fixed durable inputs that does not simply seek to replace natural degradation of capital*"[13]. However, it then applied that in an extraordinary way. Having accepted that the changes would "*accommodate use of the facilities by heavier aircraft*" and "*allow increased frequency of use by certain aircraft*", it held that the investments were only "*partly new*". In reaching its decision to exclude this investment the Commission said, "*There have been no comments from users on the scale and scope of this project. Lacking substantive comments from users, the Commission is not in a position to conclude that this project meets the requirement of this guideline*". [14]

This meant that Perth Airport could not recover the cost of the investment through increased charges, and the investment will not go ahead. Perth Airport has issued a "*Notice to Airmen*", stopping planes larger than 737 size from landing on the runway. Perth Airport is only doing minimal maintenance on the runway, which will eventually have to be replaced, at great expense.

(c) Freight Australia

Freight Australia has a 45 year lease, with associated maintenance responsibilities of the intrastate rail track in Victoria. It also operates its own freight services. The business was purchased from the Victorian government in May 1999 with access agreements in place with passenger operators, and the foreshadowing of an access regime to be declared for freight services. On 1 February 2001 the Minister for Transport announced that, effective 1 July 2001, a state access regime would be introduced to cover Victoria's freight network infrastructure.

Freight Australia believes that the proposed access regime is inconsistent with that proposed at the time of sale of the network to Freight Australia. The ORG has wide discretionary powers in determining access disputes brought before it and wide-ranging powers to demand information. The pricing principles in the proposed regime do not allow the recovery of the initial investment in the infrastructure, approx $90 million by way of a pre-payment of the

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12 ACCC, Perth Airport: Proposal to increase aeronautical charges to recover the costs of necessary investment, April 2000

13 ibid p.18

14 ibid p.26

lease rental. As a result of the problems with the proposed access regime, under direction from the RailAmerica board, Freight Australia has suspended discretionary capital expenditure as due to the threat to its sustained viability.

3. Maintaining Investment Incentives: Managing Regulatory Risk

3.1 The Objective in Striking the Balance

Every investment decision involves risk assessment. Decisions to invest in natural monopoly infrastructure are no different. However, as the Commission has identified, the risks which face those investing in natural monopoly infrastructure have more extreme consequences because the investment, once made, is sunk.[15] The sunk nature of the costs makes reliable assessment of the regulatory risk before the investment is made critical. To maintain an acceptable balancing of interests, what the regulatory environment must provide is a mechanism for delivering sufficient certainty about the likelihood of regulation and the framework within which, decisions as to regulated terms and conditions of access will be made. Such a mechanism would facilitate transparency and appropriate signalling of the nature and extent of regulatory risk which, in turn, would provide appropriate signalling to capital markets. Ensuring regulatory risk is set to preserve the incentives for investment is crucial to the development of the Australian economy, given the asymmetry in the consequences of over- and under- compensating investors[16].

This is not to suggest that investors in natural monopoly infrastructure should be given special treatment or have guaranteed returns. Rather, it is to suggest that the unique project risk, which investors in natural monopoly infrastructure face, should not be heightened by excessive regulatory intervention to a level which results in sub-optimal levels of investment.

Clearly no regulatory regime is going to, in effect, provide a guarantee to an investor that no matter what changes occur in technology, market demand or other factors, a particular piece of infrastructure is immune from regulation. What a regulatory regime can do, however, is to provide a credible and reliable mechanism for assessing the risks of regulation *ex ante*, and provide a mechanism for limiting the boundaries for regulation if regulation is to occur. The advantages of this type of structure are that:

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[15] Position Paper p.58, "*Such risks are not unique to investments in bottleneck infrastructure. Indeed, all investments involve risks of some sort. However, the fact that most infrastructure investments once made are largely sunk, means that the unique project risk is higher than for many other investments."*

[16] Position Paper pp60-61 esp Box 3.6

(a) it disciplines the coverage body and the regulator to consider issues at the time the firm is facing the investment risk;

(b) it obliges the coverage body and the regulator to support their opinions with explicit findings on issues of fact which cannot be changed in any arbitrary way;

(c) *ex ante* risk assessment is less costly.

Therefore, the key attributes of a regulatory regime for investors considering new investment (whether greenfields or upgrades of existing infrastructure) are:

- certainty and consistency in the regulatory environment;
- the provision of an appropriate level of return so that an environment is created which creates appropriate incentives for investment[17];
- sufficient transparency and review mechanisms available to it to ensure that there is a broad level of confidence in the system across all stakeholders.

The present regulatory environment does not have these features. The regulatory mechanisms are highly intrusive and are not conducive to appropriate ongoing investment in new infrastructure and in capital upgrades of existing infrastructure. In order to address these issues AusCID believes that the regulatory regime should:

(a) provide more explicit guidance to the regulator on pricing principles;

(b) provide a mechanism for reliably testing *ex ante* whether new investment will be subject to the access regime;

(c) contain a pre-investment framework undertaking which commits the regulator and the infrastructure owner from the time the investment is made to a series of principles which will govern the terms and conditions of access during the period of the undertaking/life of the asset.

These proposals are consistent with the guiding principles which the Commission's Position Paper outlines as being appropriate to access regulation, namely that:

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[17] As the Commission noted in its Position Paper at p62, this does not involve regulating all greenfield projects to ensure that they only achieve marginal returns but requires a regulatory environment which ensures that "*across this class of investments - including failures - and making appropriate allowances for risk, **average returns to investors** might well be close to normal.*" (emphasis added)

- the objectives of access regulation and guiding principles for its application should be clearly enunciated. In this regard, AusCID recommends that these objectives should receive explicit consideration by the relevant decision makers rather than operate merely as an overall objective with the limitations which the rules of statutory construction would necessarily impose on that process;

- these guiding principles must give proper regard to the needs of investors in essential infrastructure facilities;

- given the asymmetry and the costs of under- and over- compensation of facility owners, together with the informational uncertainties facing regulators, there is a strong in principle case to "*err*" on the side of investors;

- given the costs of inappropriate intervention and the practical difficulties of intervening efficaciously, it is important that access regulators are not overly ambitious; and

- the costs potentially associated with efforts to remove monopoly rents fully might suggest that the focus of regulators should be a more modest one of reducing demonstrably large rents.[18]

3.2 The Nature of Regulatory Risk

The Commission has identified the greatest potential cost from access regulation as *"the possible disincentive for investments in essential infrastructure services"*.[19] The Commission correctly notes:

> *"In essence, third party access over the longer term is only possible if there is investment to make these services available on a continuing basis. Such investment may be threatened if inappropriate provision of access, or regulated terms and conditions of access, lead to insufficient returns for facility owners. While the denial or monopoly pricing of access also impose costs on the community…, they do not threaten the continued availability of the essential services concerned. Thus,*

[18] Position Paper p.71.

[19] Position Paper at pxviii

over the longer term, the costs of inappropriate intervention in this area are likely to be greater than the costs of not intervening when action is warranted."[20]

AusCID endorses the Commission's findings in this regard. These findings are consistent with the experience of AusCID's own membership, the broader investment community and with those that are detailed by the Commission in its Position Paper.[21]

The problem of adequately addressing regulatory risk was raised by Professor King in his submission to the Commission. The problem is well described by the Commission as follows:

"…King argues that access regulation can deter prospective investments, even if regulated access prices provide a reasonable rate of return for the facilities concerned. Underpinning this argument is the notion that there is always a possibility that a prospective project might prove to be unsuccessful. Hence, if regulated access prices for ***successful*** *projects provide a return to investors sufficient only to cover the (risk-adjusted) cost of capital for those projects, then the average return across a diversified holding of projects would be less than the cost of capital…*

"Implicit in the King argument is the notion that likely exposure to access regulation if the project proves to be unsuccessful lowers the prospective returns below the level needed to justify investment."[22]

There are two aspects to the risk of regulation. First, the prospect of any regulation. Secondly, the risk of inappropriate regulatory decisions as to the terms and conditions of access.[23] The issues in relation to each are slightly different. The first is principally an issue of whether circumstances exist which would warrant declaration or coverage. The second has a focus on ensuring that the key parameters of any outcome on terms and conditions of access to a regulated service are consistent with the incentives and risks facing an infrastructure owner at the time a decision is made to invest.

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[20] Position Paper pxviii-xix

[21] Position Paper at p63 and APAC submission at pp5-6: see also section 2.3.

[22] Position Paper at p60

[23] The Commission recognises the role of the terms and conditions of access at p.145 of its Position Paper where it says *"The precise impact on future investment incentives will reflect the terms and conditions of access…rather than declaration as such."*

These two issues are at the heart of concerns about the *"chilling effect"* described by the Commission. In considering how these issues are best addressed, it is important to recognise that these assessments are being made by both investors and regulators before the actual investment is made. This has several consequences:

- it may not be appropriate or desirable for details of a proposed investment to be subject to the process of public consultation, which is used in the context of investment which has already become sunk; and

- any consideration of whether a given regulatory environment should apply to a particular investment should not, by that consideration alone, necessarily involve a conferral of power on the regulator to impose terms and conditions on that investment.

AusCID believes that the access regime should provide a potential infrastructure owner with a means to obtain certainty on the scope of regulation and the parameters which will be used to set terms and conditions. These are considered separately.

3.3 Testing Whether this is an Appropriate Asset for Regulation

As access regulation is still relatively new in Australia, there is ongoing uncertainty as to the assets which will be covered by Part IIIA. Whilst the body of knowledge is growing, it still has significant limitations.

At present, the access regime mechanisms under Part IIIA do not enable an investor to seek any form of preliminary determination from the Council or the relevant Minister as to the likelihood of a particular service being subject to regulation. By contrast, clause 1.22 of the Gas Code enables a "*Prospective Service Provider*", namely the potential investor, to request an opinion from the Council as to whether a proposed pipeline would meet the criteria for coverage contained in the Code. Clause 6.23 of the Code provides that the Council may provide an opinion in response to any such request, but the opinion does not bind the Council on any subsequent application for coverage of the pipeline.

There is considerable merit in advance indications about the prospect of an imposed regulatory outcome. What it seeks to achieve is some level of reliability in decision making from the coverage body and some transparent mechanisms as to the application of the criteria for coverage. The assessment of the criteria involves key issues about matters such as service identification, whether the relevant infrastructure has natural monopoly characteristics and whether these characteristics enable it to exert market power in an upstream or downstream

market. Advance consideration of these issues can be done in a low cost way which has the potential to provide reliable guidance to investors. Such a mechanism could have been used in the Tarcoola to Darwin rail line where, if it were to have been the subject of a declaration application there would have been real doubt if access would promote competition in another market because of the competitive discipline exercised by road transport.

AusCID proposes that there be a mechanism established under Part IIIA to enable a potential investor to obtain an advance ruling as to whether proposed infrastructure would satisfy the declaration criteria. The Gas Code model is a useful starting point, however, it is flawed for two reasons. First, it does not oblige the Council to provide an opinion in response to any request by a Prospective Service Provider. And secondly, any opinion given does not bind the Council. The first can be addressed and should not be contentious. Instead of providing that the Council "*may*" issue an opinion, the obligation in clause 6.2 can be converted to one in which the Council "*must*" provide an opinion. The second is more difficult because of the nature of any such process, and the fact that there may be significant changes in the factual scenarios between the time at which an opinion of this kind is provided and when an application for a service to be declared or a pipeline to be covered is made.

AusCID therefore proposes that a prospective investor should be able to request a binding opinion from the Council as to whether or not the criteria for declaration are satisfied in relation to a proposed investment. The Council would then be obliged to consider that request and either:

(a) issue an opinion as to whether or not the declaration criteria were satisfied with a statement of reasons as to whether the Council was satisfied in relation to each of the criteria; or

(b) issue a statement that it was not in a position to make an assessment as to whether or not the declaration criteria would apply based upon the material provided to it by the prospective service provider.

Any opinion which the Council provided would be binding on the Council in any future application for declaration of the asset except where:

(a) information provided to the Council by the prospective service provider was, at the time it was provided, inaccurate or reasonably ought to have been known by the prospective service provider to be inaccurate; or

(b) there is a material change in any of the facts found by the Council in issuing its opinion. The onus of proof of such change would be on the Council.

To make such a process effective, there should be:

(a) no appeal mechanisms from the binding opinion which is issued;

(b) a mechanism for the opinion to be revoked:

(i) if there was information provided by the prospective service provider which was, at the time it was provided, known to the investor to be inaccurate or which the prospective service provider reasonably ought to have known was inaccurate; or

(ii) there is a material change in circumstance.

Any intention to revoke would have to be subject to notice being issued by the Council and accompanied by reasons. The decision to revoke could be reviewable by the prospective service provider in the Australian Competition Tribunal or, alternatively, the decision to revoke could be made only by the Australian Competition Tribunal on the application of the Council. This is an equivalent form of process to that contained in section 50A of the TPA.

As the determination of whether or not something should be subject to access regulation would not involve questions of return or detailed financial information, it is possible that this process could be conducted as a public process within defined time periods. An alternative would be that the process would be a private one but one in which the Council would have the power to compel production of documents by the prospective service provider.

Any application for an opinion would be solely a right of the prospective service provider and no application could be made by any potential access seeker.

The nature of this binding opinion makes it important that there be a separation between the roles of determining the assets subject to regulation and determining the terms and conditions on which regulation should apply. AusCID agrees with the Commission's view that: *"separation is likely to promote transparent and independent decision making on coverage issues."*[24] The Council has no interest in ensuring that assets are subject to regulation. The ACCC will be the very body which determines that regulatory scope, and it is, in AusCID's

[24] Position Paper, p.229.

view, inappropriate for those roles to be combined. This distinction between the policy issues that are involved in coverage, and the different issues involved in determining terms and conditions of access are acknowledged by the Commission in its report on the Prices Surveillance Act and are incorporated into its finding that pricing inquiries must be undertaken by a body that is independent of the price regulator. The nature of a binding advisory opinion is not likely to be productive if the ACCC is both the determiner of whether the criteria are satisfied and the entity which imposes terms and conditions through dispute resolution mechanisms.

4. Safe Harbour Mechanisms

4.1 The Available Options

There are a number of ways in which the problems inherent in new investment in infrastructure can be addressed. The principal ones are:

(a) access holidays of the type discussed in Chapter 7 of the Position Paper;

(b) scope for a pre-investment undertaking in accordance with the process currently used by the ACCC for undertakings under Part IIIA of the Act;

(c) a particular type of undertaking which may be called a framework undertaking - in essence, this would provide a pre-investment binding framework within which specific access terms and conditions would then be set;

(d) a form of pre-investment binding regulatory contract between the service provider and the regulator which commits the parties to the basis on which access will be provided;

(e) an evidentiary notification trigger to set, at the time the investment is made, certain parameters on which any terms and conditions of access will be based;

(f) blanket exemption from the operation of the access regime, possibly with price and quality monitoring.

Which mechanism is appropriate will be heavily conditioned by precise definition of the protection which is designed to be afforded. In the following discussion, there is an analysis of some of these alternate proposals and some comment on the issue which each seeks to address.

The issue of new investment is one which applies both to greenfield infrastructure, which is focussed on by the Commission in its Position Paper, and also to capital upgrades which affect

the nature of the services which the infrastructure owner is capable of providing. Capital upgrades in this sense does not encompass mere expansions of capacity but designates infrastructure investment which creates new service opportunities. For example, the construction of the new Domestic Express terminal at Melbourne Airport would fall into this category, as would the new container terminal development at Melbourne Port.

To provide some certainty about the way in which access regulation will be applied to new infrastructure, AusCID's first preference is for the undertaking mechanisms to be amended to enable an investor to submit a framework undertaking which will be binding on the ACCC or other dispute resolution body in any subsequent arbitration on the terms and conditions of access. This seeks to enable an infrastructure owner to factor in appropriate levels of risk and ensure proper returns to address those risks, i.e., it establishes the parameters for regulatory decision making assuming regulation will be applicable at some point during the life of the asset. Section 4.2 sets out the way in which the Commission proposes that this will work in practice. If this were not favoured by the Commission, AusCID would suggest the use of evidentiary notification mechanisms. Section 4.3 sets out how these would operate in practice.

4.2 Pre-Investment Access Undertakings

Undertakings were designed to be a mechanism which infrastructure owners would utilise readily, and which would provide a low cost means of resolving terms and conditions of access because the parameters of that resolution were set out in the undertaking. However, in practice, that scenario has not played out. It has been demonstrably a time-consuming, resource intensive process to obtain acceptances of an undertaking by the ACCC and the information which has been sought has gone far beyond what would reasonably be required if an undertaking were intended to provide a framework for negotiations rather than in and of itself provide access seekers with a ready made contract.[25]

(a) Undertakings by the Owner or Operator of the Service

Whilst Part XIC only permits undertakings after declaration of a service, Part IIIA of the Act, has a mechanism by which a person who is or "*expects to be*" the provider of a service for the purposes of Part IIIA of the Act can give a written undertaking to the Commission in connection with the provision of access to that service. This provides scope for pre-investment undertakings to be provided if the identity of the service provider is known.

[25] See for example rejection by the ACCC of the Melbourne Airport undertaking and rejection of the Duke Energy International undertaking for the Eastern Gas Pipeline.

Whilst submissions to the Commission have illustrated some practical issues which have arisen with this, AusCID would support retaining the limitations on those who can submit an undertaking to the owner or operator. To do otherwise has the potential to change the voluntary nature of the undertaking process.

The importance of the voluntary nature of the undertaking process is recognised by the Commission[26] and, in AusCID's view, is a fundamental aspect of the regime. Specific issues such as those raised by ARTC and the South Australian Government in their submissions[27] to the Commission should not override the more general purpose of undertakings. Those specific issues may well be able to be dealt with through alternate mechanisms if the issue is of significance in a particular situation. For example, in a competitive bid scenario, the bid conditions could provide for the successful bidder to acquire a particular special purpose company which was then to become the service provider[28].

(b) The Nature of Undertakings

The undertaking process was designed to provide a pro-active mechanism which infrastructure owners were likely to utilise. In practice, however, the way in which the undertaking process has operated has not encouraged the use of undertakings. One of the reasons for this is that instead of undertakings providing a framework for the determination of terms and conditions of access in a subsequent bilateral negotiation or arbitration, the ACCC, in interpreting the requirements of an undertaking and, in particular, the requirement that an undertaking be "*enforceable*", has imposed a very high level of prescription on the provider of an undertaking in virtually every aspect of its business. This seems to come from an underlying philosophy that the undertaking mechanism enables a service provider to avoid the declaration and arbitration processes which are set down in the Act and that in return for that "*exemption*" a high level of prescription should be required. In some instances, the ACCC has sought to extend the scope of an undertaking so that it covers more than a specific service and instead applies to all aspects of the entities' relevant business regardless of whether or not (in relation to the broader category of services) there was scope to exercise market power which derived from the natural monopoly infrastructure. Clearly the scope of undertakings should be

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[26] Position Paper at p186

[27] For example the fact that an undertaking cannot be used where a project is subject to a competitive tendering process and the successful bidder is uncertain: see pp188-189 of the Position Paper.

[28] This may have other issues associated with it in that it may restrict the structuring opportunities which are available in a given situation. However, that simply reinforces the fact that this is a situation specific problem which would not warrant changes to the current structure of the arrangements.

confined to services where there is the potential for the exercise of market power derived from the ownership or operation of the natural monopoly infrastructure. An undertaking is not a mechanism for broad corporate regulation. Its terms must be service specific.

With the alignment of the criteria for assessing proposed undertakings with those applying for declared services and the testing of the effectiveness of existing regimes[29], undertakings will be seen more clearly in their proper context and not as a mechanism to assert broad regulatory controls on the operation of a service providers business. Even with the current structure of the undertaking mechanisms AusCID does not agree with the ACCC's approach that because an accepted undertaking means that declaration of the service will not occur, it must necessarily involve some high level of prescription. Access is facilitated where undertakings are provided. It removes the requirement for an access seeker to pursue the declaration process and the use of undertakings should be encouraged as a way of more speedily addressing access problems. Any undertaking must provide a mechanism for "*dispute resolution"* so that the framework of an undertaking is one which is basically conditioned on the same steps as those set out following declaration, i.e. negotiation and arbitration. In this regard it does not circumvent the need for resolution of issues as between access seeker and service provider. It does enable the parties to select an arbitrator other than the ACCC but otherwise there is no reason to expect that an arbitrated undertaking outcome will lead to a materially different outcome from the declaration process. Currently the philosophy which is applied by the ACCC in considering undertakings is one which provides a positive disincentive to their use. AusCID does not consider this to be in the interests of facilitating access and enhancing efficiency.

To address this AusCID believes that the fundamental nature of an enforceability requirement for an undertaking should not be equivalent to an obligation that the undertaking effectively set out all contractual terms as between the parties so that the regulator can effectively seek specific performance of a contract in accordance with the terms of the undertaking. Rather, the undertaking should provide the clear boundaries within which an access arrangement can be negotiated. It should be enforceable in the same sense in which a section 87B Undertaking is enforceable; namely, that there are severe consequences for failure to comply with the undertaking. Within an undertaking, an access seeker will always have the ability to refer a dispute to the dispute resolutions provided for in that undertaking.

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[29] Proposal 7.6

In AusCID's view, the level of prescription which the ACCC currently requires is excessive and arises from the breadth of the discretion which is conferred on the ACCC in its consideration of undertakings. AusCID suggests that this needs to be addressed to make undertakings a plausible option for infrastructure providers.

(c) AusCID's Proposals For Reform of Undertaking Mechanisms

AusCID's primary submission is that the reformulation of the undertaking criteria should make it explicit that an undertaking is designed to provide a framework for access arrangements and must include a dispute resolution mechanism. Included in the criteria for assessment of an undertaking should be:

- an explicit requirement that the terms and conditions of access to the service covered by the undertaking promote the efficient use of, and investment in, the relevant facility;
- the pricing principles dealt with in Chapter 9 of the Position Paper;
- acknowledgement that the role of an undertaking is not to set up a specifically enforceable contract but to establish the framework for negotiation.

If it were not considered appropriate to address the issue of general undertakings in this way, AusCID would argue that there should be a special category of undertaking provided for in relation to new investment. In other words, a mechanism should be established for a special type of undertake known as a "*framework undertakings*" to deal with new investment. These framework undertakings would be undertakings which set the parameters for the terms and conditions of access. Generally, the process and procedures for these framework undertakings would be the same as those for the current form of undertaking. However, the process is likely to be speedier because the same level of detail would not need to be considered. This process could be conducted in a public context.

4.3 Evidentiary Notification

Another possible proposal involves a more bilateral arrangement between the regulator and the infrastructure owner as to the parameters which will be used in determining the terms and conditions on which access will be granted and seeks to correlate them with the actual incentives for a particular investment decision.

Under the present regime, there is scope for determinations of cost base to be made quite divorced from the actual cost base and without regard to the risk factors and expected returns

which an asset was forecast to deliver when the investment was made. As the Commission notes, *"relating observed profitability for a successful facility to its expected profitability prior to investment would be highly problematic."*[30] As Professor Stephen King noted:

> *"Access pricing rules that allow a 'reasonable' return on investment do not avoid [the] problem. For example, suppose that if declaration is successful, access prices are set by the Regulator to cover the cost of investment, including a 'risk premium'. So long as there are some potential situations where the investment will be ex-post unprofitable, the potential for access will distort the expectant investment return and may make the investment unprofitable."*[31]

Some factors which impact on the decision about appropriate terms and conditions must be made at the time those terms and conditions are set. Others relate to cost structures and decisions made by the investor at the time the investment commitment is made. Those which relate to costs, and decisions made by prospective investors should be able to be fixed based on the facts as they occur.

To implement this type of system, there could be provision for a prospective infrastructure owner to provide the regulator (i.e. the ACCC) on a confidential basis, with the factual basis for the investment decision. This would include:

- details of the assessment of the prudence of the proposed investment, and estimated rates of return;
- risk assessments made;
- expected life of the asset;
- actual costs incurred.

This material, once furnished to the ACCC, would, if any dispute as to access terms and conditions ever arose, be presumptive evidence of all of the factual materials which were provided. The ACCC would be obliged to use this material as the basis for any determination of terms and conditions unless there were a manifest error in any of the material which had been provided.

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[30] Position Paper, Box 7.4, p192.

[31] Position Paper p60.

This mechanism ensures that arbitrariness does not play a part in regulatory decisions which should take proper account of the incentives which face the investor at the point in time at which the investment decision was taken.

These factual matters will not be determinative of the terms and conditions. A number of other factors which will need to be taken into account are factors which vary with the passage of time and market conditions. Such a presumptive application of factual material would, however, eliminate material areas of risk which have arisen to date.

4.4 A Role for Access Holidays?

In the Position Paper[32] the Commission suggested use of *"access holidays"* to address the problems associated with new investment. It was proposed that an access holiday could be implemented by way of a null undertaking which would have the following features:

(a) investments to provide essential infrastructure services where none currently exist could be exempted from Part IIIA for a defined minimum period of, say, 15 or 20 years;

(b) acceptance of a null undertaking for this period could be automatic, unless the regulator could demonstrate that it would not be efficient, for example, where:

- the project ex ante appears highly profitable; or
- the standard exemption period is excessive - for example, 15 to 20 years may be too long for sectors such as telecommunications, where technology is changing rapidly; and

(c) null undertakings would not apply to extensions to, or augmentation of, existing facilities, or the development of new facilities associated with network infrastructure.

[32] Position Paper pp189-194

The Commission appears to use as its trigger for the availability of an access holiday, the marginal profitability of an infrastructure investment. It states:

> *"The potential 'chilling' effect which access regulation can have on investment in essential infrastructure facilities was discussed at length in chapter 3. Where new bottleneck infrastructure projects are expected to return only normal profits (that is, to be only marginally profitable, allowing for risk), any diminution of expected returns as a result of exposure to access regulation will almost inevitably deter investment. To counter this sort of impact, Professor King (sub.1), among others, has suggested the use of access holidays.*
>
> *"Under an access holiday approach, proposed projects which were expected to be only marginally profitable could be exempt from declaration for a designated period (the access holiday), thereby providing the owner with the opportunity to recoup capital costs free of the threat of access…*
>
> *"On considering the theoretical literature and the views of participants, the Commission considers that investments which are only expected to be marginally profitable should not be subject to access regulation"*[33].

This seems necessarily to involve an ex ante assessment by the regulator of the likely profitability of the project. Apart from the difficulties inherent in that approach, one must first ask why it is that an investment in natural monopoly type infrastructure is likely to be only marginally profitable. There seem to be two possible explanations:

(a) First, notwithstanding its natural monopoly characteristics, the infrastructure in question faces downstream competition which constrains the exercise of market power by it.[34]

(b) Secondly, the level of demand for the product is uncertain. This can be an issue particularly in relation to new products or new technology[35]. An example is the new Domestic Express Terminal at Melbourne terminal which was constructed and then lost two thirds of its volume over night as a result of the Impulse-Qantas merger.

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[33] Position Paper at pp189-190

[34] Position Paper at pp40,

[35] See comments of the Australian Competition Tribunal in Duke Eastern Gas Pipeline decision on development of

In the first of these scenarios, the issue is not one which goes to the terms and conditions on which an asset will be regulated but rather to whether this is an appropriate asset to be regulated under the regulatory scheme which is in place. In AusCID's opinion, this scenario is not best suited to the use of access holidays. Rather, as suggested in section 3, the regime should provide for some mechanism to test this issue pre-investment, rather than presenting an investor with a choice between relying on the advice it has received about whether the conditions for declaration are satisfied or submitting an undertaking to limit regulatory risk.[36] An access holiday is not focused on the question of whether this is an appropriate kind of asset for regulation; such an assessment can only be made by comparing the proposed project against the relevant criteria for regulation. Marginal profitability is not an appropriate proxy for determining whether or not infrastructure is likely to satisfy the criteria required for regulation.

The second scenario is one which is fundamentally driven by the terms and conditions on which access would be made available. The mechanisms which are appropriate for those issues are ones that are targeted to the substantive content of terms and conditions of access. In such a scenario, it seems to be difficult to ascertain a clear trigger for determining when an access holiday would apply.

Therefore, whilst supportive of the philosophy underlying access holidays, AusCID believes that better options can be used which are more clearly targeted to the issues being addressed. An "*access holiday*" is a broad and potentially blunt instrument. The Commission identifies many of the weaknesses which are inherent in the use of access holidays. Others have been identified in the Joint Industry Submission on the Productivity Commission's Review of the National Access Regime[37].

In addition, an access holiday, if not a de facto exemption, will be followed by regulated terms and conditions, which are not known at the time of investment. These could be extremely onerous, with regulators seeking to claw back benefits said to have been enjoyed during the access holiday. Such perceived benefits will often be illusory. An examination of the

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gas demand in regional areas.

[36] In this regard, the Commission has noted at p188, "*[I]n practice, it may be important to allow undertakings even where coverage is uncertain in order to mitigate regulatory risk. While providing an access route for essential services which need not be covered would seemingly be pointless, a facility owner might volunteer an undertaking purely as a device to reduce risk. In such a case, efficiency is likely to be enhanced. Reducing regulatory risk is likely to be particularly important in the life of an access regime when coverage decisions may be difficult to anticipate.*"

incentives facing a company would suggest that early in the life of the asset, there is a strong argument for terms and conditions of access which are favourable to access seekers as the infrastructure owner seeks to build market demand for the services provided by its asset. Introducing the notion of an access holiday at this point is likely to achieve little in a practical sense and be fraught with the difficulties of implementation, which are detailed by the Commission in its report.[38]

Whilst there is superficial appeal to an access holiday, it does not address the real issues which face investors.

5. Proposed changes to the declaration criteria

5.1 The Commission's proposals

The Commission concluded that there are some deficiencies in the current declaration criteria that could lead to the inappropriate declaration of services. Those deficiencies are reflected in:

- the scope for declaration to proceed, where the effect on competition would be trivial; and
- weakness in the natural monopoly criteria, which could allow coverage of services without substantial and sustainable market power.

The Commission made two recommendations, identified as Tier 1 and Tier 2 recommendations, to counter these deficiencies.

Proposal 6.1 contains the Tier 1 changes which are that the Part IIIA declaration criteria should be modified as follows:

- s.44G(2)(a) be amended to: "*that access (or increased access) to the service would lead to a substantial increase in competition in at least one market, other than the market for the service*"; and
- s.44G(2)(b) be amended to: "*that it would be uneconomic for anyone to develop a second facility to provide the servic*e".

[38] Position Paper pp189-194

AusCID supports the Commission's underlying objective that the hurdle for declaration should be sufficiently high so as to ensure that inappropriate declaration of services does not occur. Since the Commission issued its Position Paper, the Australian Competition Tribunal has delivered its decision in relation to coverage of the Eastern Gas Pipeline. This decision is of significance in a number of respects but has particular importance in relation to the Commission's proposed Tier 1 changes to criterion (a).

Given these developments, the Tier 1 changes may not be as significant as when the Sydney Airport decision stood alone. This increased certainty gives rise to some concern that the potential costs of the proposed changes may outweigh the benefits that may follow, because:

- the changes have the potential to increase the level of uncertainty surrounding declaration, by reducing the efficacy of the body of case law that is developing as to the meaning of the existing criteria; and
- there is limited evidence to suggest that the current criteria have led, or will lead, to a flood of inappropriate declarations;
- the changes will be construed to have been made in order to change the approach which previously existed, when warrant for that would seem to be limited.

5.2 Promotion of competition - Tier One recommendation

There are three elements to the proposals which the Commission makes in relation to this criterion:

(a) that the increase in competition for the criterion to be satisfied must be substantial - AusCID endorses this aspect of the proposed changes;

(b) whether it is necessary that competition be promoted or substantially promoted in an identified market;

(c) whether the market in which competition is to be promoted should be confined to a market in Australia.

(a) Substantial Promotion of Competition

The concerns about the operation of this aspect of the criterion, as set out in the Commission's Position Paper appear to derive from the Australian Competition Tribunal's decision in *Re: Review of Freight Handling Services at Sydney International Airport*[39]. The Commission states:

> "*If the competition promoted as a result of mandated access were to be only marginal, declaration would be of little practical benefit and could even be damaging for the economy.*
>
> *It might seem unlikely that the regulator or the courts would regard a marginal increase in competition as sufficient for declaration. Yet on the evidence presented, the Sydney Airports case - the only successful court adjudicated declaration to date - indicates that criterion (a) can be satisfied in a manner which leads to access being granted in instances where it would promote only a marginal increase in competition with potentially ambiguous efficiency effects.*"[40]

In addition to the Sydney Airports decision, there is now the decision of the Australian Competition Tribunal in *Re: Application under section 38(1) of the Gas Pipelines Access Law for Review of the Decision by the Minister for Industry, Science and Resources published on 16 October 2000 to cover the Eastern Gas Pipeline pursuant to the provisions of the National Third Party Access Code for Natural Gas Pipeline Systems and the Gas Pipelines Access Law* (" **Eastern Gas Pipeline Decision**"). That decision is of particular importance to the consideration of this criterion by the Commission because:

- the Tribunal adopted the approach to the interpretation of criterion (a) used by the Tribunal in the Sydney Airports case; but
- found that the evidence did not demonstrate that there would be a promotion of competition.

In the Eastern Gas Pipeline decision, the Tribunal said:

> "*The meaning of this term was discussed by the Tribunal in Sydney International Airport. The Tribunal said (at 40,775) that the notion of "promoting" competition:*

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[39] (2000) ATPR 41-754

[40] Position Paper at p131

> *'involves the idea of creating the conditions or environment for improving competition from what it would be otherwise. That is to say, the opportunities and environment for competition given declaration, will be better than they would be without declaration.'*

> *The Tribunal concluded that the TPA analogue of criterion (a) is concerned with the removal of barriers to entry which inhibit the opportunity for competition in the relevant downstream market. It is in this sense that the notion of promotion of competition involves a consideration that if the conditions or environment for improving competition are enhanced, then there is a likelihood of increased competition that is not trivial. We agree."*[41]

The Tribunal went on to formulate the scope of the inquiry required under paragraph (a) as being, "*whether the opportunities and environment for competition in market(s) upstream or downstream of the EGP would be enhanced if the EGP were to be covered in terms of the Code, than if it were not."*[42]

Having considered the evidence the Tribunal concluded that:

> " *EGP will not have sufficient market power to hinder competition based on the commercial imperatives it faces, the countervailing power of other market participants, the existence of spare pipeline capacity and the competition it faces from the MSP and the Interconnect. As EGP does not have market power, the Tribunal cannot be satisfied that coverage would promote competition in either the upstream or downstream markets."*

In AusCID's view, to the extent that there have been problems arising in the application of criterion (a), they are problems of applying particular factual situations to this criterion rather than to any difficulty inherent in the interpretation of this criterion. That said, AusCID is supportive of amendments which ensure that inappropriate declaration does not occur and is therefore supportive of the Commission's recommendation that the criterion be amended to provide that, "*access (or increased access) to the service would lead to a substantial increase in competition in at least one market, other than the market for the service*."

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[41] para 75

[42] para 83

(b) Identification of a market

However, AusCID is concerned about the Commission's expressed preference to amend paragraph 44G(2)(a), by substituting a test for the promotion of competition in a downstream or upstream activity, for that of another market. While this preference is not contained in the recommendation, and while it picks up the wording of the Hilmer Report, it carries significant difficulties because:

- if there is no separate market;
- then all one is testing for is increased competition in the resupply of the monopoly service.

The notion of "*activity*" does not simplify anything. Rather, it complicates matters, because the notion of testing for competition can only be by reference to a market. By definition competition occurs in markets and whilst market definition may not always be simple, if a separate market cannot be identified, then the service should not be declared. This issue was also addressed in a submission by Network Economics Consulting Group to the Commission[43].

(c) Market in Australia

Removing the requirement that there be a market in Australia addresses principally distributional issues and generally the Commission has not supported access regulation as a means of pursuing distributional goals.[44]

The Commission's conclusion that the rider "*whether or not in Australia*" serves no beneficial purpose appears to contain some assumptions about benefits deriving to Australia if competition is generated overseas. The Commission states:

> *"Thus, for these goods in which Australia is a major supplier with the potential to influence world prices, additional competition induced by an access regime could have a depressing effect on those prices. This would not be a concern if it was an incidental effect of providing access in a manner that improved overall economic efficiency. However, the Commission sees no case for promoting access where, the*

[43] Submission no.39 at p16

[44] Finding 5.1

> *access seeker aside, the only benefit would be to overseas consumers in the form of lower prices for Australian goods and services."*[45]

This seems to contain an assumption that benefits derived in Australia will remain in Australia. This may be questionable and the level of economic activity within the country may provide a better proxy for overall Australian welfare. If that is the case imposing a requirement that the market be in Australia will not necessarily achieve the desired objective.

(d) A "*second facility*"?

AusCID supports the Commission's view that, "*declaration should, as far as practicable, be confined to essential infrastructure involving natural monopoly technology…This is to confine the reach of the regime to that class of infrastructure where the negative effects from the misuse of market power are likely to be greatest."*[46]

This approach has been confirmed by the Australian Competition Tribunal in its recent Eastern Gas Pipeline Decision. In that decision, the Tribunal said that:

> "*[W]e accept that if a single pipeline can meet market demand at less cost (after taking into account productive, allocative and dynamic effects) than two or more pipelines, it would be 'uneconomic', in terms of criterion (b), to develop another pipeline to provide the same services."*[47]

This approach is consistent with the approach to criterion (b) preferred by the Commission in its Position Paper[48].

Given that the current state of the decisions from the Council and the Tribunal reflect a position which is consistent with the preferred approach of the Commission, AusCID has some reluctance to effect any changes which will necessarily be interpreted to change the status quo. It is not clear what has prompted the proposed change to criterion (b), shifting from "*another facility*" to a "*second facility*". It seems designed to overcome a view expressed by the ACCC, in its submission to the Commission, that the present criterion (b) could apply to duopolies and oligopolies. AusCID agrees with the Commission that criterion (b) should not catch duopolies

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[45] Position Paper p132

[46] Position Paper p136

[47] Eastern Gas Pipeline Decision at para 64

[48] Position Paper p136

and oligopolies but notes that the ACCC seems to have been alone in expressing the view that the criterion is either designed to or is likely to do so.

One concern which AusCID has with the proposed "*second facility*" test is that it could be interpreted as requiring a substantially similar or identical facility, and therefore does not permit the current approach to the criterion of testing for substitute services. As a consequence, the criterion could become locked into a technology-specific focus on the facility in respect of which access is sought. The concern is one that is expressly acknowledged by the Commission. This concern is significant in light of the approach which the ACCC took to this criterion in the development of the Domestic Express Terminal at Melbourne airport.

In light of there being little practical need to clarify the ambit of paragraph 44G(2)(b), and in order to overcome the technological specificity to which the current proposal is probably prone, in AusCID's view there is no change required to be made to the declaration criteria. However, if the matter is pressed, then the Commission might wish to consider the addition of the following words to the end of paragraph 44G(2)(a):

> "… , *which is not presently provided by any other person*;"

This would have the effect of focussing the criteria only on monopolies while removing the risk of a technology-specific focus on secondary facilities. Criterion (b) would therefore read:

> "*that it would be uneconomical for anyone to develop another facility to provide the service being a service which is not presently provided by any other person*."

5.3 Tier Two recommendations - Is the reworking required?

The Tier Two recommendations embody a far reaching set of changes, which involve significant re-drafting of the declaration criteria, however, the intention appears to be to create an outcome with substantially the same result as the outcomes which are now being seen from the current criteria. AusCID supports the objectives which the Commission outlines as being appropriate in identifying appropriate infrastructure for regulatory coverage. AusCID agrees with the Commissionthat the regulatory regime should:

- have explicit criteria which clearly express the purpose to which each is directed. This will have the effect of limiting the discretion vested in decision makers;
- target natural monopoly infrastructure where the control of that natural monopoly infrastructure enables the owner/operator to exercise a substantial degree of market power in a dependent market; and

- ensure that access is only granted where to do so would significantly improve efficiency.

What is more difficult to assess is whether the amendments which have been proposed will bring about the result desired by the Commission. What has been proposed involves quite a different approach both in terms of the economic framework used and also in terms of how the criteria would operate in practice. AusCID, while supportive of the intent, is concerned that the proposals may have the effect of increasing uncertainty with no assurance that the outcome of the application of the criteria will provide at least as high a threshold as currently applies.

Under the Tier Two recommendations the criteria would read as follows:

(a) the service is of significance to the national economy and the entry of a second provider of the service would not be economically feasible;

(b) no substitute service is available under reasonable conditions that could be used by an access seeker;

(c) competition in downstream markets is insufficient to prevent the provider of the service from exercising substantial market power;

(d) addressing the denial of access, or the terms and conditions of access, to the service concerned is likely to improve economic efficiency significantly;

(e) access to the service is not already the subject of an effective access regime; and

(f) access (or increased access) to the service would not be contrary to the public interest.

5.4 A screening test

The Commission proposes the introduction of a criterion which requires it to be established that, "*A service is of significance to the national economy and the entry of a second provider of the service would not be economically feasible."*

This is intended to cover two principal aspects of identified infrastructure. First, that the service should be of significance to the national economy. And secondly, it imposes a loose test of monopoly which finds expression in the notion that entry by a second provider would not be economically feasible.

AusCID is concerned about the notion of economic feasibility which has been introduced. The term "*economically feasible*" is not a term of art in economics and has no immediate meaning to economists. Indeed, to an economist the notion of "*feasibility*" tends to suggest some notion of a commercial viability assessment rather than broader economic notions. The term is also not one which has been used to date in Australian competition law or the jurisprudence of any other country so far as AusCID's researches have been able to ascertain. It is not used in any other statute and therefore is likely to give rise to significant uncertainty. Given the meaning which has now been clearly attributed to "*uneconomic to develop another facility*", i.e., whether a single facility can meet market demand at less cost (after taking into account productive, allocative and dynamic effects) than two or more facilities, it is unclear what benefits would be derived from the proposed change. In addition, it will be assumed that the change was brought about in order to alter the position which existed under the preceding interpretation.[49]

The proposed reformulation of this criterion is that it speaks of "*the entry of a second provider*". That on its face may be thought to require new entry rather than utilisation of existing infrastructure. This issue has been dealt with by the Tribunal in the Eastern Gas Pipeline decision. As to the meaning of "*to develop another pipeline*" the Tribunal in that case said:

> *"A literal construction of criterion (b) might require the decision maker, in the application of the criterion, to ignore the existence of pipelines which have already been developed. That is not the approach adopted by NCC in its Final Recommendation. NCC said at 47:*
>
> > *"… the Council considers the objectives of the legislative scheme are best met by also having regard to the provision of competing services by another existing pipeline for the purposes of criterion (b) …"*
>
> *There is no logic in excluding the existing pipelines from consideration in the determination of whether criterion (b) is satisfied. The policy underlying the Code would not be advanced if the Tribunal were to proceed in that blanket way. We therefore think it appropriate to enquire whether the MSP or the Interconnect provide or could be developed to provide the services provided by means of the*

> *EGP. The proper characterisation of those services is itself an issue of construction which is addressed later."*[50]

On one view, the Commission's use of the term "*entry of a second provider*" may be intended to refer to entry in the sense of making available precisely the same service rather than one which is intended to refer to the underlying issues of the making available of a new facility as such.

AusCID also notes that the question of national significance is left at large to be determined by the decision maker without the benefit of the current specifications of matters which would satisfy national significance, namely:

- the size of a facility; or
- the importance of the facility to constitutional trade or commerce; or
- the importance of the facility to the national economy.

Absent these limiting factors, the decision maker will have greater discretion as to the interpretation of "*national significance*". AusCID would regard this as generally undesirable and inconsistent with the overarching approach of the Commission, which is to limit the discretion which is applied by the decision maker in these scenarios.

5.5 An essentiality (market power) test

The Commission identifies its proposed two part essentiality test as being "*a means of assessing whether the service provider is in a position to exercise market power*".[51] It is said that the test should involve the identification of the scope for substitution in both production and consumption. AusCID agrees that no access regulation is warranted unless there is natural monopoly infrastructure and ownership and/or operation of that infrastructure enables the owner/operator to exercise a substantial degree of market power in a related market.

Under the present criteria, these issues are dealt with in criterion (b) in the identification of infrastructure with natural monopoly characteristics and in criterion (a) in seeking to identify whether those natural monopoly characteristics operate as a material constraint on downstream competition.

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[50] Eastern Gas Pipeline decision paras 55-57.

[51] Position Paper p144.

The motivation for the Commission's two part essentiality test seems to be designed to pick up substitution possibilities both in production and consumption. AusCID recognises the importance of both demand and supply side substitution possibilities. The very notion of competition carries with it both supply side and demand side substitution possibilities. It is not therefore clear to AusCID why such a two part test is required.

AusCID is also concerned about the first part of the essentiality test involving a notion of a substitute service being available under "*reasonable conditions*". It is not clear how such a proposition would be tested. Would it require an access seeker to demonstrate *ex ante* that it had been offered terms and conditions and that they were unreasonable? What level of proof would be required by the decision maker of the reasonableness or otherwise? Would this involve, in effect, a pre-determination of matters which are fundamentally the terms and conditions on which access may be granted? In other words, does it effectively reverse the process to require consideration of reasonableness of terms and conditions before any determination as to whether this is the appropriate type of infrastructure for regulation?

These considerations present serious issues for both an access seeker and an infrastructure owner. Any assessment prior to declaration of the reasonableness of terms and conditions which may have been offered will significantly shift the dynamic in the very process itself and will materially increase costs to all parties. It will also remove the benefits which would arise from the Commission's proposals for an undertaking to be able to be submitted after declaration of the service, and is likely to delay significantly the process.

5.6 A materiality test

The aim of the Commission's materiality test is that it would significantly improve economic efficiency, having regard to the ability of the infrastructure owner to exercise market power, and the effects on users of the service and on future investment that would be occasioned by addressing that power through an access regime[52]. For the reasons outlined in section 2.2 ,AusCID supports the more explicit recognition of economic efficiency considerations. Efficiency considerations are, however, complex, involving issues of dynamic, allocative and productive efficiency. Moreover, they are very difficult to measure and quantify. As the Commission notes in several places in its Position Paper, the approach which has been adopted in economic regulation found in the Trade Practices Act to date is that competition will generally encourage efficiency and competition is therefore used as somewhat of a proxy for efficiency. Because of the difficulties inherent in measurement of efficiency considerations,

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[52] Position Paper p145.

AusCID's preference is that the criteria retain a focus on competition but that the objectives of Part IIIA explicitly refer to efficiency considerations, and that the decision maker be directed to take those objectives into account in its application of the specific criteria.

6. Issues in the Terms and Conditions of Access

6.1 Pricing Principles

AusCID sees the introduction of appropriate pricing principles within the TPA as a critical issue arising out of the Commission's Position Paper. As outlined earlier, it is the terms and conditions on which access is granted that have the key impact on incentives for investment. There are two broad issues. First, the uncertainty as to the level at which pricing will be set in the current process. Secondly, the level at which access prices are set and the appropriateness of non-price terms and conditions.

Much of the focus since the introduction of the access regime has been on a highly intrusive building block approach to the determination of a provider's cost and, in effect, a form of rate return regulation. This has occurred seemingly without regard to the broader consequences of this prescriptive approach. AusCID endorses the submission of the Council, adopted by the Commission,

> *"It needs to be recognised that it is not possible or desirable in all circumstances to completely eliminate excess returns. More specifically, there is a trade off between setting prices so as to reflect costs on the one hand, and providing incentives for continued improvements in productivity and efficiency on the other. A pricing regime that sought to force price continually down to cost would erode the incentives regulated firms had to drive costs down or in other ways to innovate."*[53]

The issue has also been put well by IPART, which said:

> "*The history of intrusive cost plus regulation is replete with examples of heavily regulated industries that exhibit low levels of efficiency, poor investment practices and below average service performance. Both theory and experience indicate that repeated frequent confiscation of the benefits of efficiency improvements combined*

[53] NCC's submission to the Productivity Commission pages 28-29.

with uncertainty of a future regulatory actions will lead to poor performance and welfare loss."[54]

AusCID therefore endorses the Commission's statement of what should be the proper objective in pricing regulation, namely "*to improve on unregulated outcomes, but recognise that precision is not possible with the information and instruments available*".[55]

AusCID supports the pricing principles which have been proposed by the Commission.

In addition to those pricing principles, AusCID considers that there is merit in adding to these principles by including an explicit bias for productivity based approaches to pricing. AusCID is firmly committed to incentive regulation being the foundation of pricing principles. AusCID supports the inclusion of the following additional pricing principles:

(a) regulators should be required to respect the principle of financial capital maintenance;

(b) regulators should be required to include strong incentives for producers to achieve productivity improvements;

(c) regulators should be required to ensure a fair sharing between producers and consumers of the gains from productivity improvements and technological changes.

6.2 Extensions to Existing Facilities

In relation to extensions, the Commission endorsed the following comments made by the National Competition Council in its submission:

"In some situations, the needs of an access seeker can only be met by:

- *extending the geographical range of a facility; or*
- *expanding the capacity of a facility.*

These are matters that, in the first instance, should be subject to negotiations between the parties. But clause 6(4)(j) [of the Competition Principles Agreement]

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54 Independent Pricing and Regulatory Tribunal 1999, *Regulation of Electricity Network Service Providers - Incentives and Principles for Regulation*, Discussion paper DP-32, Sydney, January.

55 Position Paper at p207

requires that where agreement cannot be reached, the arbitrator must be empowered to require an extension, provided certain conditions are met.

Clause 6(4)(j) elaborates on these conditions, covering:

- *technical and economic feasibility, and safety considerations;*
- *the owner's legitimate business interests;*
- *adjustments to access tariffs to reflect the costs and benefits of the extension to the parties.*

The Council considers that geographical extensions should not necessarily be the responsibility of a facility owner. It may be appropriate for a business seeking geographic extensions to undertake the necessary construction work itself and gain access to an existing facility through interconnection. For this to be feasible, an access regime would need to empower the arbitrator to require interconnection provided the 6(4) conditions are met. This approach was adopted in the National Gas Regime."[56]

The Commission endorsed these submissions and also argued that "*there is merit in empowering an arbitrator to require interconnection (subject to feasibility and the access seeker bearing the costs), rather than the current formulation of requiring the operator to extend the facility."* In relation to enhancements to facilities the Commission concluded that:

"Regardless of the circumstance, the Commission considers that directly mandating investment represents an unwarranted intrusion into the commercial dealings of private firms."

These findings collectively lead to proposal 6.8 as part of the Tier 1 recommendations:

"When arbitrating a dispute for a declared service, the ACCC should be able to require that a service provider permit interconnection to its facility by an access seeker. However, scope for the ACCC to require extensions of facilities should be removed."[57]

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56 Position Paper at p165

57 Position paper p166.

AusCID supports this recommendation.

6.3 Capacity Enhancements of Existing Infrastructure

The Commission made a finding in its Position Paper that it did "*not see a case for including 'capacity expansions' within the meaning of section 44V and W (the Part III counterparts to clause 6(4)(j).*"[58] However, this finding does not appear to have found its way into any explicit proposal. AusCID endorses the Commission's view that requirements for capacity expansions go beyond the legitimate reach of an access regime. This should be an explicit recommendation of the Commission.

[58] Position Paper p165.