Productivity Commission review of the national access regime

Response to submission DR125
made by the National Competition Council

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1 Introduction

On 9 August 2001, the Network Economics Consulting Group Pty Ltd ("NECG") provided a submission[1] to the *Review of the National Access Regime* by the Productivity Commission (the "PC"). That submission gave detailed consideration to the role and proper interpretation of the "uneconomic to develop" criterion for mandated access under the National Third Party Access Code for Natural Gas Pipelines (the "Gas Code") and under Part IIIA of the Trade Practices Act 1974 (Cth) (the "Act") in the wake of the decision of the Australian Competition Tribunal (the "Tribunal") in the *Duke Eastern Gas Pipeline*[2] case.

The National Competition Council ("NCC") has made a submission[3] to the PC in response to NECG's earlier submission. NECG takes this opportunity to respond briefly to the NCC's submission.

NECG firmly rejects any suggestion that it has:

- misrepresented the Tribunal's decision or the evidence put before the Tribunal;
- misrepresented the NCC's position on declaration criteria; or
- altered its views in relation to the issues underlying the decision in *Duke* or the relevant analysis of those issues.

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1 Network Economics Consulting Group, "The 'uneconomic to develop' criterion after *Duke*", Submission to the Productivity Commission's *Review of the National Access Regime*, 9 August 2001, available at: http://www.pc.gov.au/inquiry/access/subs/subdr116.pdf.

2 [2001] ACompT 2 (4 May 2001) ("*Duke*").

3 National Competition Council, Review of the National Access Regime – Submission in response to Submission DR116 (NECG): *The 'uneconomic to develop' criterion after Duke*, September 2001 (available at: http://www.pc.gov.au/inquiry/access/subs/subdr125.pdf) (the "NCC Submission").

Ordinarily, NECG would provide a strong detailed reply to the NCC Submission setting out the various flaws in the “analysis” the NCC purports to undertake on the issues raised by NECG.

However, NECG is mindful that the present inquiry is imminent in closing and, as such, the PC would likely find it far more helpful if NECG were to focus its rebuttal on the gravamen of the issues arising out of the *Duke* decision as relevant to the PC’s current inquiry. This, then, is the primary focus of this submission. A secondary focus of this submission is to address the particular issue of the relationship between excess capacity and natural monopoly – a relationship which the NCC has, in our view, fundamentally misunderstood. The appendix to this submission deals with this latter issue.[4]

Essentially, there are two fundamental points that the NCC has either failed to address or misconstrued, namely that there are a number of very sound reasons as to why:

- policy-makers and regulators should guard against the risk of regulatory error in mandating coverage (either of a pipeline under the Gas Code or any facility under Part IIIA of the Act). This is particularly so where the choice is made to err on the side of coverage when in fact, properly analysed, coverage should not be mandated in the particular case; and
- any inquiry into the applicability of criterion (b) of the Gas Code,[5] or its equivalent under Part IIIA of the Act,[6] should unambiguously incorporate a proper economic analysis. As currently construed, on the basis of the *Duke* decision, the ‘uneconomic to develop’ criterion may well be specified in terms that will result in too many

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[4] If the PC has any additional concerns, in the wake of the NCC Submission, regarding the accuracy or validity of any of the material presented by NECG in its earlier submission, NECG would be more than happy to respond to such concerns in detail.

[5] It will be recalled that criterion (b) of clause 1.9 of the Gas Code sets out one of the criteria for coverage of a pipeline under the Gas Code, namely “that it would be uneconomic for anyone to develop another Pipeline to provide the Services provided by means of the Pipeline”.

[6] Section 44G(2)(b) of the Act (“that it would be uneconomical for anyone to develop another facility to provide the service”).

pipelines being covered under the Gas Code (or, equivalently, facilities declared under Part IIIA of the Act).

Both of these aspects are dealt with briefly below.

2 Avoiding regulatory overreach

As noted, there are a number of very sound reasons as to why policy-makers and regulators should guard against the risk of regulatory error in mandating coverage (either of a pipeline under the Gas Code or any facility under Part IIIA of the Act). This is particularly so where the choice is made to err on the side of coverage when in fact, properly analysed, coverage should not be mandated in the particular case.

Although this issue – guarding against regulatory error - goes to the very heart of good regulatory policy and design, and of the regulatory scope issues at the centre of the PC's *Review of the National Access Regime*, the NCC has essentially not responded to this aspect of NECG's earlier submission at all (presumably because it agrees with this surely uncontroversial proposition).

To reiterate the thrust of NECG's earlier submission:

- it is a well-accepted proposition that a policy of granting excessively liberal third party access can impose significant costs. Moreover, given that third party access implies price regulation, and given that the social costs of setting access prices too low or too high are asymmetric, community welfare is maximised by erring against allowing access in marginal cases; and
- this asymmetry of costs, and the policy value of erring against the granting of access in marginal cases, in turn underscores the importance of maintaining strong and effective "filters" against regulatory intervention that set a high threshold for imposing rights of compulsory access by third parties.

As these propositions are uncontroversial, the relevant question is whether the existing coverage criteria under the Gas Code and Part IIIA of the Act constitute effective regulatory filters against regulatory overreach in the area of mandated access, so that community welfare is maximised.

3 'Uneconomic to develop' as a regulatory filter

The "uneconomic to develop" criterion was intended to be an important filter against inappropriate regulatory intervention, however, to act as such, it must be interpreted as a test of whether a firm has such substantial market power over the supply of a service as to confer the capacity to act as a bottleneck to effective competition in dependent markets – that is, in markets in which firms can only compete if they have access to that service. This implies an interpretation that requires a demonstration that there is no alternative, in an economic sense, to obtaining the relevant service from the facility in question.[7] Necessarily, this approach involves assessing the market in which the service of the facility is being offered and examining the availability of substitute sources of supply within that market. If the "uneconomic to develop" test is not interpreted in this manner, there is a high probability that access to facilities will be granted in cases in which it is not economically efficient to do so.

The decision in *Duke* makes it clear that the existing 'uneconomic to develop' criterion is in need of amendment to ensure that it fulfils its intended purpose.

The Tribunal explicitly rejected the need for formal application of market definition principles in the determination of the "uneconomic to develop" criterion. By doing this, the Tribunal rejected the necessity for considering a complete range of relevant substitutes that encompassed ***not only*** those alternatives that provided precisely the ***same*** service as the facility/pipeline at issue, but also those services that, while not ***identical*** to the service provided by the facility/pipeline at issue, were ***sufficiently similar*** that they were effective substitutes/alternatives. Clearly, this approach means that it is not necessary to rule out the existence of ***all*** economic substitutes for a service.

Accordingly, the Tribunal's approach to the "uneconomic to develop" criterion creates the risk that, by defining the "service" of the facility/pipeline in too narrow a manner, the decision-maker will ensure that there will be no other services that are substantively similar to those provided by that facility. As such, the "uneconomic to develop" criterion, as

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7 That is, there are no other services that act as a direct and material constraint on the pricing of the service to which access is sought to be mandated. This is equivalent to defining the market in which these services are supplied.

interpreted by the Tribunal in *Duke*, sets an inefficiently low threshold for regulatory intervention.

Whilst the NCC may take issue with the application of particular analytical tools or methodologies in particular cases to reaching decisions regarding available substitutes,[8] it does not dispute that the substitutability issue is at the core of the inquiry. The fundamental point of departure appears to be in the starting point for determining the proper market definition.

The NCC's understanding of the market definition process seems to be that one takes any definition of the service that is provided by the firm that one feels like, and then applies a SSNIP test to this service. What the NCC does not seem to realise is that the initial choice of the service to which the test of substitutability is applied is not an automatic one. There will always be a number of ways to define a "service" provided by a facility. Intelligent market definition recognises this, and experiments with different approaches to the "service" to which the substitutability test is applied to ensure that an unduly restrictive starting point for the definition of the "service" does not rule out the existence of genuine economic substitutes for the service provided by the facility.

4 Conclusion

Whilst there may well be room for debate on the relevant methods to be applied in analysing the 'uneconomic to develop' criterion, there is at least a potential for a significant *de facto* loosening of the hurdles that need to be met before third party access can be mandated.

The NCC has submitted that:

> "The Tribunal explicitly established a test of natural monopoly or natural monopoly characteristics for the consideration of criterion (b) …
>
> Even if there were some merit in the NECG arguments about flaws in the Tribunal's application of a natural monopoly test, this would hardly amount to

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[8] And NECG notes that it is in the nature of any analytical tool that its outputs are sensitive to the assumptions and specifications it employs.

> cause for amendment of the legislation. Criterion (b) would retain its test of natural monopoly. The proposition that the Tribunal's decision robs the "uneconomic to develop" test of any practical bite, or that the test will be met wherever a facility has excess capacity, is without foundation."[9]

NECG strongly rejects the NCC's contentions. There are clearly sound arguments for recognising, at a minimum, that there is scope for achieving far greater clarity than presently exists in relation to the interpretation of the 'uneconomic to develop' criterion. Given the costs that exist with any lack of clarity on this issue, NECG does not understand why the NCC finds the prospect of increasing regulatory certainty and avoiding potential regulatory overreach, so threatening.

Although there are a number of potential ways in which clarity might be achieved, NECG's view is that it would be possible to introduce a limited amendment to the current criterion (b) so as to explicitly refer to the existence of alternatives in the market for the services of the facility in question. For example, the criterion could be modified to read:

> (b) that it would be uneconomical for anyone to develop another facility to provide the service or a substitute for the service in the same market as that in which the service is provided;

A limited amendment, such as that set out above, would retain the guidance provided by current case law as to the meaning of "uneconomical", while being able to draw on the extensive precedent that exists with respect to market definition. It could be made speedily, without requiring far-reaching reconsideration of the overall statutory scheme. And last, but by no means least, it would eliminate the serious risks the *Duke* decision now creates.

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[9] NCC Submission, page 16.

Appendix

Excess capacity and natural monopoly

The NCC states that:

> "The proposition that the Tribunal's decision robs the "uneconomic to develop" test of any practical bite, or that the test will be met wherever a facility has excess capacity, is without foundation."[10]

The above and a number of other assertions by the NCC on the relationship between excess capacity and natural monopoly are particularly questionable as a matter of economics. The purpose of this appendix is to briefly comment on that relationship.

In its submission, the NCC states:

> "… it should be noted that the MSP has spare and developable capacity to meet the gas needs of NSW with decreasing costs for some considerable time into the future. Unless it can be said that there is a discreet [*sic*] bundle of demand for the transportation of gas from Longford to Sydney, the EGP would constitute uneconomic development of a pipeline to provide the services of the MSP."[11]

This statement arguably seeks to equate excess pipeline capacity (with declining costs) with natural monopoly. Clearly, this view cannot be universally correct as a matter of economic theory. There are a number of reasons for this including that it ignores, first, dynamic considerations and, secondly and even more basically, the pipeline's role in the industry production function. For example, transportation capacity is of no consequence if sufficient gas (at a competitive price) is not available for transport.

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[10] NCC Submission, page 16.

[11] NCC Submission, page 12.

These shortcomings are amply illustrated in *Duke*. The EGP was built in large part on a view that supplies from Moomba would not be sufficient to satisfy demand in the New South Wales and Australian Capital Territory destination centres at a competitive price, despite the sunk cost advantage enjoyed by the MSP prior to the construction of the EGP. The mere fact that the MSP had (or could have) ample capacity to transport all gas needed in New South Wales or the Australian Capital Territory for a "considerable period", while not irrelevant to the decision to build the EGP, clearly was not sufficient to deter the construction of another gas pipeline to serve these destinations. In fact, there is no dispute that the EGP was, in both a private and a social sense, an economic development decision.

Nor does this conclusion rely in any way on the assertion that there must be a "discreet [*sic*] bundle of demand for the transportation of gas from Longford to Sydney". Such a "discreet [*sic*] bundle" is irrelevant to users of gas in Sydney (that is, they are indifferent to the physical point of origin). There is also no such "discreet [*sic*] bundle" from the producers' perspective, since they are indifferent to the destination of physical transportation, but clearly reap advantages in terms of competitive position and sales revenues when additional destinations are available.