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National Farmers' Federation

Inquiry into the National Access Regimes

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NFF

Executive Summary

The National Farmers' Federation (NFF) welcomes the opportunity to provide its views to the Productivity Commission inquiry into third party access regimes. We believe this inquiry will have an important bearing on the regulatory model to apply to access regimes for key economic infrastructure services, and hence the terms and conditions (costs) of access faced by rural and regional Australia.

This submission focuses on two issues of central concern to rural and regional Australia: (i) the adequacy of infrastructure and (ii) access to, and pricing of, infrastructure services.

Access to, and the adequacy of, competitively priced infrastructure is of vital concern to rural and regional Australia. The NFF sees the regulation of third party access to infrastructure as important in ensuring competition in the provision of services, thereby providing benefits such as lower prices, choice of service provider and more innovative and better quality services. In turn, this will increase the competitiveness of downstream industries from rural and regional Australia, such as dairy, rice growing, food processing and fertilizer plants, providing employment and underpinning regional development.

The NFF considers that 'light-handed' regulation in the face of information and resource asymmetries is not likely to produce the benefits that access regimes should provide for consumers and producers. We believe 'light-handed' regulation in the form pursued by asset owners will allow the persistence of monopoly rents and lead to deadweight losses for the economy, all to the detriment of consumers and industries in rural and regional Australia.

The Industry Commission made its reputation in fighting fearlessly against the deadweight losses imposed on Australia and her export industries through tariffs. The Productivity Commission should not lend intellectual legitimacy to the imposition of hidden taxes on Australian industry in the form of specious charges for access to essential infrastructure. Marginal cost pricing is the rule for economic efficiency and we expect the Commission to defend that rule against the vested interests of infrastructure owners.

The emphasis in securing commercial rates of return on infrastructure investments in Australia's regulatory approach has generated an in-built bias against the concept of externalities. These are important to the process of planning and funding new investment by the public sector or for contributions from beneficiaries rather than from users alone. Unless recognised, much required infrastructure may never be built.

The use of replacement cost valuations of infrastructure assets (DORC) have been directed by State governments in some sectors and have in the main been accepted as a standard by regulators upon which to construct price regulation. This has often resulted in higher prices than otherwise might be the case, reduces downstream competition and

investment, and result in monopoly rents being embedded in Australia's infrastructure networks.

Concerns for Australia's international competitiveness should have a higher weighting in regulatory regimes. The whole system of third party access regulatory reviews must result in enhancing the competitiveness of downstream industries. The current regulatory approach needs to apply reality tests (e.g. internal rates of returns) and international performance benchmarks to ensure that regulatory outcomes do enhance Australian competitiveness.

The NFF recommends that the Productivity Commission considers the following:-

- Ensure appropriate and effective regulation (in access regimes) that promotes increased contestability, recognises the potential for market failure and constrains the monopoly power of incumbents in the regulated market. The Inquiry should assess the regulatory approaches, whether 'light-handed' or 'heavy-handed' regulation, to determine whether they are 'appropriate and effective' and are achieving the required outcomes.
- Ensure adequate information disclosure provisions in access regimes to enable greater transparency, accountability and economically efficient outcomes.
- Suggest ways of ensuring that access regimes give greater weight to the achievement of downstream allocative efficiencies.
- Recommend a system that allows beneficiaries to contribute to infrastructure investments.
- Review the appropriateness of DORC as the standard regulatory asset valuation methodology.
- Review resourcing for participants in regulatory processes and recommend the provision of funding for users/consumers to enable a more informed debate and a level regulatory playing field.
- Devise a mechanism (for example, using reality tests and international performance benchmarks) by which regulators in all access regimes can ensure that regulatory outcomes do enhance Australia's international competitiveness and require regulators to apply it.

1. INTRODUCTION

The National Farmers' Federation (NFF) welcomes the opportunity to provide its views to the Productivity Commission inquiry into third party access regimes. We believe this inquiry will have an important bearing on the regulatory model to apply to access regimes for key economic infrastructure services, and hence the terms and conditions (costs) of access faced by rural and regional Australia.

Access to, and the adequacy of, competitively priced infrastructure is of central concern to rural and regional Australia. Given that Australian primary producers face intensely competitive export markets, it is totally unacceptable if their costs are inflated by monopoly rents embedded in infrastructure costs. Inflated infrastructure costs also adversely impact on rural and regional consumers and act as a disincentive to businesses locating in regional and rural Australia. Accordingly, the NFF sees third party access to infrastructure as providing competition in the provision of services, thereby providing benefits such as lower prices, choice of service provider and more innovative and better quality services. In turn, this will increase the competitiveness of downstream industries from rural and regional Australia, such as dairy, rice growing, food processing and fertilizer plants.

This submission focuses on two issues of central concern to rural and regional Australia: (i) the adequacy of infrastructure and (ii) access to, and pricing of, infrastructure services.

2. Information Disclosure And 'Light-Handed' Regulation

Information disclosure is critical for efficient and informed economic regulation. The NFF is concerned with the push in some quarters to rollback informed regulation under the guise of a preference for 'light-handed' regulation to avoid delays, uncertainty and regulatory costs. This approach has taken the form of favouring price-cap regulation i.e. CPI-X (applied in the early days of privatisation in the U.K) as opposed to cost of service rate of return regulation (described by some as 'heavy handed' regulation).

However, the anti thesis between price-cap regulation and cost of service rate of return regulation can be shown to be a false one. While CPI-X regulation can give incentives in starting a regulatory regime where there is "fat" in the system, in the final analysis there is no avoiding of the questions of cost and rates of returns if one wishes to avoid abuses of monopoly position.

It is useful to note the experience of 'light-handed' regulation in the U.K., which was intended to avoid the litigious USA regulatory procedures. Carpenter and Lapuerta[1], drawing on the experience of British gas regulation, conclude that:

1 Carpenter, Paul and Carlos Lapuerta (1999) A Critique of Light-Handed Regulation, Northwestern Journal of International Law and Business, February 2000

> "First, light-handed regulations has not worked as anticipated to avoid the need for lengthy regulatory proceedings. Second, light-handed regulations has unintentionally created inefficient incentives for regulated companies. Third, light-handed regulation has not successfully constrained the monopoly power of incumbents."
>
> "British regulators have found reasonable prices cannot be determined without an inquiry into the costs of the regulated company. British regulatory practice has had to respond by becoming more heavy-handed, performing similar cost analysis to those traditionally performed by United States regulators. Unfortunately the regulated companies have the advantage of knowing their costs far better than the regulator, and have systematically used their advantage to the detriment of consumers. Light-handed regulation has also created inefficient incentives and allowed regulated companies to abuse their market power."

The analysis by Carpenter and Lapuerta are supported by the views of other U.K. commentators such as Beesley and Whittington. Professor Whittington has observed that:-

> "Experience since privatisation has shown very clearly that price cap regulation does not avoid the need for calculating the rate of return.....This process has now become a routine aspect of regulation in telecoms, gas, water, electricity and airports."[2]

Moreover, Beesley (former UK gas regulator) in proposing additional techniques for effective incentive regulation argues that "useful debate will involve a much greater willingness to disclose information."[3]

The intent of Hilmer and Part IIIA was effective regulation, as apposed to 'heavy handed' or 'light-handed' regulation. Australian regulation is focussed on analysis of the capital costs of utilities, and that is regarded as appropriate given the capital intensity of infrastructure networks. Earlier experiences with 'light-handed' regulation (e.g. the 1996 and 1997 gas access determination by the New South Wales Independent Pricing and Regulatory Tribunal) reveal that consumers have not fared well and third party access competition did not happen because the regulator was unable to obtain sufficiently robust cost and revenue information.

Effective or 'informed' regulation needs to be supported by adequate information disclosures. Here the experience of Australian third party access and price regulation reviews have varied widely. For example, some State-based regimes (e.g. in the Hunter Water review) provide for minimal disclosures of information (e.g. on financial and cost data) and consumers are unable to have sufficient information to enable derivation of their charges and tariffs. In other regimes, such as the National Third Party Access Code for Gas Pipelines, information disclosure provisions are adequate, but the willingness of regulators to insist on disclosure varies, and regulators are frequently

[2] Geoffrey Whittington, Regulatory Asset Value and the Cost of Capital, 1998

[3] M.E. Beesley, RPI-X: Principles And Their Application To Gas. Regulation Series V Lecture

subject to regulatory 'gaming' by asset owners. The 22 months gas pipeline access review conducted by the NSW Independent Pricing and Regulatory Tribunal in 1999 and 2000 is a classic case of cat and mouse regulation in Australia, and reflects, in part, the information (and resources) asymmetries faced by both consumers and regulators.

We also urge the Commission to consider the impact that lack of disclosure/transparency has had in discouraging potential entrants to emerging/contestable markets. For example, the NSW rail access regime contains barriers to entry (in the form of increased costs, uncertainty and business risk) that result from a lack of disclosure so that third parties have difficulty determining what they have do to secure access or have predictable outcomes. In addition, the previous monopoly provider (Freight Corp) retains control over some of the elements of the infrastructure network and lack of disclosure (or perhaps lack of action by regulator?) makes it difficult for third parties to access those elements of the network

Accordingly, the NFF seeks appropriate and effective regulation that promotes increased contestability recognises the potential for market failure and constrains the monopoly power of incumbents in the regulated market. We consider that this can be better achieved if there is adequate disclosure of information to the market (e.g. cost of service data, cost allocation methodology, and asset base register) so as to enable consumers to understand the derivation of their tariffs or charges, and to establish that they are fair, reasonable and economically efficient (i.e. devoid of monopoly rents).

3. Deadweight Loss (Excess Burden)

The NFF wishes to draw attention to the crucial economic concept of deadweight loss (or excess burden) which is due to excessive infrastructure charges. We believe that it is incorrect to seek to separate the existence of monopoly rents from economic inefficiency by suggesting (as the Commission's Issues Paper appears to) that monopoly rents may merely be income redistribution devices. Any monopoly rents levied by infrastructure owners represent a form of taxation of intermediate inputs to production or of consumers. For example, inflated electricity or gas network charges feed into the costs of energy users (e.g. irrigators and rural processing industries) thereby reducing their competitiveness, and distort production and consumption patterns.

The Issues Paper is in error in suggesting that two-part tariffs eliminate the economic inefficiencies created by the extraction of monopoly rents by monopoly network owners. Fixed access or connection charges are not lump sum charges. Unlike lump sum taxes, they do cause changes in producer or consumer behaviour and produce economic distortions. High fixed charges for rail access may simply mean some areas go out of cultivation for bulk crops. It is worth noting that road transport does not have access charges and this is the optimal pricing strategy for public network infrastructure in the absence of congestion. If roads were charged for on the basis of fixed access charges, most regional and rural communities would be closed down. Why should other infrastructure be charged for in such a detrimental way?

Although there is no strict hypothecation of road taxes, if one considers roads as being financed by registration charges (taken as an access charge) and fuel excise (taken as usage charge), the distortions created by excessive infrastructure charges become apparent. The amounts collected by these charges are well in excess of what is spent on the roads (which is why they are thought of as taxes by both lawyers and drivers rather than as fees for any service). The resulting transport costs have adversely affected rural and regional Australia and it has accordingly been recently a prime object of policy to reduce transport costs through diesel excise cuts and GST credits on petrol and other fuels used by business.

It is logically inconsistent for policymakers to recognize the adverse effects of high road transport taxes and yet accept access or usage charges for other infrastructure which embed "hidden tax" elements. It is just as illogical to tolerate such hidden infrastructure quasi-taxes while eliminating embedded sales taxes on exports by introducing GST credits for exports. The principle in all cases is the same: any charge in excess of marginal cost is a tax which feeds into production costs and damages Australia's international competitiveness. The object of rational economic policy should be the removal of all such hidden tax and cost burdens on exporters. The basic principle for efficiency is that marginal cost pricing should always be followed.

Australia is not a closed economy and distortions or inflated production costs in Australia will inevitably reduce Australian incomes and living standards – national competition policy and access regimes have serious implications for the competitiveness of rural and regional Australian industries. The emphasis of regulatory reviews and access regimes upon securing a revenue stream to service the regulated infrastructure (plus a rate of return) have meant insufficient attention has been given to downstream allocative efficiencies. This needs to be rectified. Sunk capital is sunk capital and it is quite inefficient to allocate revenue streams to owners for access where assets already exist and were often paid off years ago. Moreover, in some infrastructure sectors such as in electricity and gas pipelines, users' capital contributions have been included in the regulatory asset base by regulators, so that there is an element of double-dipping, with consumers having the privilege of paying again for the use of assets that they originally paid for.

4. Externalities And New Investments

The Commission's Issues Paper appears to have ignored the important issues of externalities generated by network infrastructure. Governments traditionally provided network infrastructure because it had positive spillover benefits for the whole economy over and above any return to private investors and these benefits justified such investments even when they would not have been commercially viable. To the extent that external beneficiaries, including Treasuries, contribute to the capital costs of infrastructure the cost base for setting access charges can be reduced. If access charges are reduced closer to marginal cost, there are efficiency gains as more use is made of the facility, and economic growth and revenue to Treasuries are maximised.

Under the present system of "users pay" network augmentation may never be undertaken if there are insufficient direct users to fund the necessary capital. However,

there may be other beneficiaries (including governments) who may benefit from the investment and should make a contribution.

The present regulatory system has seen regulators provide hight revenue streams to network owners "to provide the right prices signals to signal new investments". Yet, there is no guarantee that the network owners will necessary bring in new investments when the time comes, rather than paying the increased revenues to shareholders. The current regulatory regimes do not provide for sinking funds to ensure future new investments. There should be a system to enable cost/benefits tests to be undertaken, so that required infrastructure can be built.

5. Asset Valuation And Cost Of Capital

The measurement of the cost of capital is crucial to access regimes in practice, and hence the terms and conditions of access. In that context, the valuation of assets becomes of fundamental importance. If governments or network owners are allowed to put inflated values on assets and a regulatory regime is put in place to allow owners of these assets to charge on such inflated values, then the scope for massive distortionary pricing above average (let alone marginal) cost is very large.

There are substantial concerns with asset write-ups in State electricity and gas pipelines 'regimes'. For example, the National Electricity Code requires regulators to adopt the Deprecated Optimised Replacement Cost asset value methodology (the highest valuation methodology) in valuing transmission networks and to have regard to existing government policies when valuing distribution networks. In New South Wales, the regulator had to adopt the asset value provided by the State Treasury (which raised asset values by some $2.5 billion) while in Victoria, Tariff Orders written by the State Government have prevented the regulators from reviewing the value of the network assets. In some cases, the regulators have been prevented from conducting an optimisation of the networks thereby permitting possibly redundant or imprudent assets to be allowed into the regulatory asset base (and therefore higher prices).

We have very substantial concerns that such practices may mean that monopoly rents may be legitimised. The whole object of economic regulation under Part IIIA of the Trade Practices Act is to avoid abuse of monopoly power by ensuring that natural monopolies do not charge users more than would be charged in a hypothetical competitive market where values were constrained by the actual costs incurred by competitors.

There have been substantial research in Australia and in overseas countries criticising the use of the DORC asset value methodology. Arguments used by Professors Stephen King, David Johnstone, Murray Wells, Geoffrey Whittington, Bonbright and many others demonstrate that using DORC provides a "free lunch" in economic terms and demolish the arguments (often used by regulators) that DORC is "economically efficient".

For example, Professor Johnstone comments that the "view [that economic theory requires sunk assets to be valued at DORC] has been promulgated and recited by asset owners and the regulators themselves to the point that it is widely taken for granted, albeit without demonstration or authority. And yet the two theorists who have had most of substance to say about the regulatory asset valuation debate in Australia, Melbourne University economist Stephen King and Cambridge economist and accountant Geoffrey Whittington, have both concluded in their published works, and reports to regulators, that DORC should not be adopted, not simply because of its established impracticalities and administrative infirmities but because it is theoretically not acceptable ... The other, more astounding precedent ignored by regulators who assume the relevance of DORC is that in the USA where asset valuation for the purposes of tariff setting has a 100 year history and a massive literature, replacement cost based asset valuation has been either not taken seriously or considered and rejected. The authoritative American text on asset valuation for regulation purposes, Bonbright et al rejects replacement cost valuation as neither living up to its supposed economic justification nor being practically administrable."[4]

However, despite the academic literature and research studies which generally oppose the use of DORC, Australian regulators (and governments) continue to apply the asset value methodology in regulatory reviews.

Our strongest concern with the continued use of the DORC asset valuation methodology by regulators is that it will result in monopoly rents being embedded in the cost of Australian infrastructure.

6. Information And Resource Asymmetries

Infrastructure users in rural and regional Australia face major information and resource asymmetries and are therefore constrained from effective participation in the myriad regulatory reviews which are underway at any point of time. Regulators have also voiced these concerns – they have been rightly concerned that there should be informed debate, involving all interests, at regulatory reviews. Disclosure of information and effective participation by rural users of infrastructure can be in the interest of informed regulation and a level regulatory playing field. In the same way as the regulated entities are provided with regulated revenues for their regulatory activities by the regulators, so too should users be adequately funded to participate in regulatory reviews. We believe the National Competition Policy processes should provide for users' funding to enable a more informed debate and a level regulatory playing field.

[4] David Johnstone, Comments on Tobin's Q and the Supposed Economic Justification for Replacement Cost (DORC) Regulatory Asset Valuation, 1999.

7. Conclusion

The NFF considers that 'light-handed' regulation in the face of information and resource asymmetries is not likely to produce the benefits that access regimes should provide for consumers and producers. The experience in overseas countries where 'light-handed' regulation has been practiced is not encouraging. Concerns by asset owners in the current debate in Australia over regulatory models should be seen as reflecting a defence of private interests and rent seeking. Concerns, about delays in regulatory reviews and 'uncertainty' reflects an element of regulatory gaming. We believe 'light-handed' regulation in the form pursued by asset owners will allow the persistence of monopoly rents and lead to deadweight losses for the economy, all to the detriment of consumers and industries in rural and regional Australia.

The Industry Commission made its reputation in fighting fearlessly against the deadweight losses imposed on Australia and her export industries through tariffs. It would be a sad situation were its successor to lend intellectual legitimacy to the imposition of hidden taxes on Australian industry in the form of specious charges for access to essential infrastructure. Marginal cost pricing is the rule for economic efficiency and we expect the Commission to defend that rule against the vested interests of infrastructure owners (often governments) who are more concerned with maximizing monopoly rents (for short term budgetary purposes) at the expense of Australia's long-term growth and productivity.

The emphasis in securing commercial rates of return on infrastructure investments in Australia's regulatory approach has generated an in-built bias against the concept of externalities. These are important to the process of planning and funding new investment by the public sector or for contributions from beneficiaries rather than from users alone. Unless recognised, much required infrastructure may never be built.

The use of replacement cost valuations of infrastructure assets (DORC) have been directed by State governments in some sectors and have in the main been accepted as a standard by regulators upon which to construct price regulation. This has often resulted in higher prices than otherwise might be the case, reduces downstream competition and investment, and result in monopoly rents being embedded in Australia's infrastructure networks.

Concerns for Australia's international competitiveness should have a higher weighting in regulatory regimes. The whole system of third party access regulatory reviews must result in enhancing the competitiveness of downstream industries. The current regulatory approach needs to apply reality tests (e.g. internal rates of returns) and international performance benchmarks to ensure that regulatory outcomes do enhance Australian competitiveness.

8. Recommendations

The NFF recommends that the Productivity Commission considers the following:-

I. Ensure appropriate and effective regulation (in access regimes) that promotes increased contestability, recognises the potential for market failure and constrains the monopoly power of incumbents in the regulated market. The Inquiry should assess the regulatory approaches, whether 'light-handed' or 'heavy-handed' regulation, to determine whether they are 'appropriate and effective' and are achieving the required outcomes.

II. Ensure adequate information disclosure provisions in access regimes to enable greater transparency, accountability and economically efficient outcomes.

III. Suggest ways of ensuring that access regimes give greater weight to the achievement of downstream allocative efficiencies.

IV. Recommend a system that allows beneficiaries to contribute to infrastructure investments.

V. Review the appropriateness of DORC as the standard regulatory asset valuation methodology.

VI. Review resourcing for participants in regulatory processes and recommend the provision of funding for users/consumers to enable a more informed debate and a level regulatory playing field.

VII. Devise a mechanism (for example, using reality tests and international performance benchmarks) by which regulators in all access regimes can ensure that regulatory outcomes do enhance Australia's international competitiveness and require regulators to apply it.