Joint Industry Submission on the Productivity Commission's Review of the National Access Regime

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5 June 2001

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1. Introduction

The following major Australian corporations and associations from across a range of industries welcome this opportunity to respond to the Productivity Commission's (the 'Commission') Position Paper on the Review of the National Access Regime released on 29 March 2001 (the 'Position Paper'):

- AGL
- Aurora Energy
- Australian Council for Infrastructure Development
- Australian Gas Association
- Australia Pacific Airports (Melbourne Airport)
- Australian Pipeline Industry Association
- Australian Pipeline Trust
- Brisbane Airport Corporation
- CMS Gas Transmission of Australia
- Duke Energy International
- ElectraNet SA
- Electricity Supply Association of Australia
- Energex
- Envestra Ltd
- Epic Energy
- Ergon Energy
- Great Southern Energy Gas
- Hastings Funds Management
- Integral Energy
- SPI PowerNet
- Telstra Corporation

- TXU Networks
- United Energy
- Westralia Airport Corporation (Perth International Airport)

We welcome the Position Paper and congratulate the Commission on a valuable contribution to the public debate on this very important set of issues. The objective of this submission is to respond in detail to many of the Commission's various recommendations and requests for information and to elaborate on some of the issues raised in the earlier joint submission prepared by the Network Economics Consulting Group Pty Ltd ('NECG') and dated 18 January 2001.

1.1 Summary of key points

The purpose of this submission is to indicate that:

- the Commission has correctly identified the core objective of Part IIIA as being the enhancement of overall economic efficiency through the promotion of the efficient use of, and investment in, essential infrastructure services;
- Part IIIA, as it is currently drafted, leaves the potential for unnecessarily and unacceptably high levels of regulatory risk. This creates substantial disincentives for efficient use of, and investment in, essential infrastructure services;
- regulatory risk would be diminished, to a great extent, by amendments to the legislation that generally:
    - require certification of Commonwealth access regimes, and introduce mechanisms to limit the extent to which access regimes more onerous or far-reaching than Part IIIA can be introduced;
    - strengthen and harmonise the criteria for declaration and certification;
    - provide a mechanism for exempting investments from declaration *ex ante*, allow whole of life pre-investment undertakings and make it possible for any sharing of project benefits to be specified prior to funds being engaged, for example on the model of the Petroleum Resource Rent Tax;
    - establish the objects clause proposed by the Commission;
    - adopt the Commission's Proposal 8.1 (dealing with the inclusion of legislated pricing principles), subject to the first proposed pricing principle being modified to read 'costs prudently incurred' rather than 'efficient long-run average costs';
    - encourage regulators to utilise incentive-based mechanisms to reveal efficient costs rather than rely on estimates of these costs made by the regulators themselves;

- provide an entitlement for owners to know key elements of the regulatory cost of capital before capital expenditure commitments are made;
  - specifically allow for the risk component of the cost of capital to be fixed, at the time of investment, for the life of the investment; and
  - provide for full merits review rights in respect of decisions on undertaking applications; and
- regulatory risks will not be increased further if the current regulatory framework which provides for:
  - full appeal rights against decisions to declare services; and
  - separate regulators to deal with declaration and access decisions,

  is maintained.

1.2 Structure of this submission

The structure of this submission is as follows:

- Section 2 discusses the costs of inappropriate access regulation, particularly in terms of the impacts it may have on the incentives for efficient investment. In analysing these impacts, this section reviews the concept of regulatory risk and provides greater empirical detail on the impact of regulation on investment to date;
- Section 3 considers issues arising out of the coverage provisions of the regime and assesses measures which may be taken to reduce uncertainty in this regard. More specifically, this section examines certification of Commonwealth access regimes, tightening of the declaration criteria under Part IIIA, alignment of the certification criteria with the declaration criteria under Part IIIA, the development of mechanisms for exempting investments from the operation of the access regime and the amendment of the objects clause in Part IIIA;
- Section 4 discusses the uncertainty that exists as a consequence of the approach currently used to regulate access prices for declared services, and suggests principles and rules that could reduce that uncertainty, thereby increasing investor confidence and improving efficiency and investment incentives;
- Section 5 addresses the proposals for changes to the appeals and review processes; and
- finally, Section 6 considers the issue of whether there should be a single regulator responsible for Part IIIA.

2. Costs of inappropriate access regulation

We welcome the Commission’s detailed discussion of the potential costs of regulation, and particularly of the impact that access regulation can have on the incentives for efficient

investment. This section of the submission reinforces the thrust of the Commission's assessment by summarising a more formal analysis of regulatory risk. It also provides some additional empirical material on the impact of regulation on investment to date.

2.1 The Commission's position

The Position Paper contains a detailed discussion of the need for access regulation and of the potential costs that such regulation can impose. Importantly, the Commission concludes that:

> … it is important not to overstate the extent of market power in the provision of essential infrastructure services. While delivery of a number of these services relies on a natural monopoly technology, various competitive pressures will limit the scope for providers to restrict access and/or raise access prices. This reinforces the need for the inquiry not to dismiss the 'no regulation' option, particularly given the potential costs of remedial intervention.[1]

While the Commission states that 'it would be foolish to dismiss as unimportant the concerns underpinning access regulation', it details at length the potential costs that could be associated with access regulation and that need to be considered when designing an economically efficient access regime. Specifically, the Commission notes that:

> The costs emanating from the alteration of property rights under access regulation can take a number of forms, including:
>
> - Administrative costs for government and compliance costs for business;
> - Constraints on the scope for infrastructure providers to deliver and price their services efficiently;
> - Reduced incentives to invest in infrastructure facilities;
> - Inefficient investment in related markets; and
> - Wasteful strategic behaviour by both service providers and access seekers.[2]

Importantly, on the evidence and the submissions before it, the Commission accords priority to the potential for inappropriate access regulation to have a significant detrimental impact on the incentives for efficient investment. Reflecting this, the Commission highlights the need for pricing principles that:

> … give proper regard to the needs of investors in essential infrastructure facilities. Contrary to the suggestions of some participants, this does not mean endorsement for unfettered monopoly behaviour by service providers. However, given the asymmetry in 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'

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1 Position Paper, p. 52.

2 Position Paper, p. 53.

> on the side of investors. The challenge is how to render this principle operational without creating new problems.[3]

However, the Commission seeks further information on the impact of regulation on investment in essential infrastructure.[4]

2.2 Regulatory risk

We submit that the Commission is correct in according priority to the potential for inappropriate access regulation to have a significant detrimental impact on the incentives for efficient investment, and we welcome this opportunity to provide the Commission with further comments about the likely nature and extent of such impacts.

In the initial NECG submission, the point was made that there is an asymmetry in the consequences of over- and under-compensating investors in essential infrastructure facilities. Regulators effectively face a choice between:

- erring on the side of lower access prices, presumably so as to ensure the removal of any potential for monopoly rents and of the consequent allocative inefficiencies, from the system; or

- allowing higher access prices so as to ensure that sufficient incentives for efficient investment are retained, with the consequent productive and dynamic efficiencies such investment engenders.

It was suggested to the Commission that there are strong economic reasons in many regulated industries to place particular emphasis on ensuring the incentives are maintained for efficient investment and for continued productivity increases. The dynamic and productive efficiency costs associated with distorted investment incentives and with slower growth in productivity are almost always likely to outweigh any allocative efficiency losses associated with above-cost pricing. The Commission has accepted these important points.[5]

We submit that this line of argument is reinforced when the relationship between regulatory risk and investment incentives is considered more closely.[6]

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3 Position Paper, p. 71.

4 Position Paper, p. 65.

5 Position Paper, pp. XVIII-XIX.

6 A more formal and detailed exposition of the problem of regulatory risk may be found in *Regulatory Risk*, Draft version of a paper prepared for the ACCC Regulation and Investment Conference, Manly, 26-27 March 2001, by Henry Ergas, Jeremy Hornby, Iain Little and John Small, available at http://www.necg.com.au/pappub/papers-ergas-regrisk-mar01.pdf.

Regulatory risk arises when the interaction of uncertainty and regulation changes the cost of financing the operations of a firm. This can occur even when there is no uncertainty about the regulations, so it is useful to distinguish two (often related) ways in which regulatory risk can arise:

- although ***market uncertainty*** arises from the normal interactions between buyers and sellers across all markets (for example, external cost shocks, unanticipated technological advances, shifts in preferences and so forth), it can have more severe impacts on regulated firms because of constraints regulation imposes on their ability to respond. As a result, even when regulations are fully known and non-discretionary, regulated firms can be more exposed to the costs of normal market uncertainty than other firms; and

- additional uncertainty can and almost invariably does arise from the existence of ***regulatory discretion***. In all regulatory systems, regulators have some non-trivial decisions to make. As a consequence, the outcomes from the future stream of regulatory decision making processes cannot be predicted with certainty.

In the face of normal market uncertainty and uncertainty arising from regulatory discretion, the expected returns on any investment made by a regulated firm can be distorted. Examples of how each type of regulatory risk arises are as follows:

- consider a highly predictable form of regulation such as a 20-year price cap. As cost and demand conditions evolve through time, the level of the cap limits the extent to which the firm can adjust to new information. History shows that large swings do occur and these can undermine the profitability of any firm. However, such swings are more likely to have adverse consequences for a regulated firm over the long term because, for instance, such a firm is prevented by the cap from pricing high in the good times to offset the need to price low in the bad times; and

- additional problems arise when the terms of the regulations themselves are unpredictable, for example because they can be varied, with little constraint, in the context of regular resets. Even if there is no bias in the regulator's estimation procedures, so that on average the regulatory error is zero, the effect on the firm's earnings is unambiguously negative. The fundamental cause of this can be traced to the same effect as noted above – that is, the firm's ability to optimise is limited by regulation.

Where the costs of regulatory risk are neither recognised nor explicitly compensated, any attempt to regulate prices to the level of "cost"[7] will actually impose economic losses, reducing if not eliminating the incentives for efficient investment over time. Investors simply will not sink money into regulated assets if expected returns, taking account of the risk of capital losses, are less than the opportunity cost of the capital.

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[7] That is, cost as measured without taking account of regulatory risk.

Dangers of bias in regulatory decision-making accentuate these effects. “Bias” here refers to a systematic pattern in decision-making, as against uncertainty, which refers to the extent to which outcomes can be predicted. Bias in decision-making can arise quite independently of any predisposition for decisions to be made in one direction or another. Regulatory decisions can, in other words, be biased even if individual regulators are not. This is because bias can arise merely from the process by which regulators are seized of some problems but not others – that is, from bias in the selection of the sample of issues that proceed to regulatory determination. In the current regulatory arrangements, bias of this type arises from the fact that access disputes are far more likely to arise with respect to successful infrastructure investments than with respect to facilities for which there is relatively little demand. If regulators, in determining the terms and conditions of access, do not fully take this fact into account, regulatory decisions can eliminate the “upside” investors might hope for from successful investments without symmetrically reducing the “downside” to which these investments are exposed.

Additional bias can arise from the wider context in which regulatory decisions are taken. In practice, regulators in Australia have been under great pressure to gain public support for the process of regulatory change. In responding to this pressure, there has been the danger that delivering, and being seen to deliver, immediate reductions in consumer prices can become an objective in-and-of-itself, pursued with great vigour and publicity but without due consideration of the wider risks to efficiency and investment. In turn, artificially inflated public expectations create further risks going forward, as the point must come at which meeting these expectations is inconsistent with sustainability.

2.3 The impact of regulatory risk

It is impossible to demonstrate conclusively the impact of regulatory risk on investment levels in Australian infrastructure. It is simply not feasible to identify what level of investment would have occurred if a narrower, more certain access regime were in place.

Nevertheless, we submit that there is extensive evidence of investor concerns about regulatory uncertainty and that these concerns are impacting upon the flow of funds into regulated infrastructure.

Among the many major investors in Australian infrastructure that have expressed significant concerns with the risks that arise from access regulation, we note the following statements by major investment houses:

- Deutsche Asset Management comments that it has not invested in regulated businesses for three years. The only exception has been its investment in the Port of Geelong, where Deutsche was given a guarantee by the regulator not to regulate the income. Among the investments Deutsche has passed up include ETSA, the Victorian gas distribution businesses and Dalrymple Bay coal terminal. Deutsche’s position is that there are significant risks in investments in regulated businesses, where the regulator can confiscate the small upside. Deutsche believes that its return to investing in

regulated businesses would require regulators to start looking at reasonable returns that take into account the risks involved in such investments;[8] and

- Hastings Funds Management comments that the risks of regulation come into play at the revenue-modelling stage. A very high discount rate is built into the models prepared by Hastings to take account of, or 'build buffers for', regulatory uncertainty. It also indicates that banks have 'been burnt' in initial asset sales, and now generally insist on 'locking in' a debt to regulated asset base ratio.[9]

These concerns have also been expressed in the press more generally. *The Bulletin* (22 August 2000), for example, reports that big Australian investors such as the Development Australia Fund and Commonwealth Investment Management have each expressed a reluctance to commit new funds to the regulated sector. Similarly, *The Age* (30 October 2000) reports AMP Investments as saying that the risks of investing in regulated infrastructure in Australia had become too great and that the company had not invested in Australian infrastructure for two years because the sector was over-regulated.

The concerns expressed by investors have a rational basis. Consider, for example, the impact of regulatory access decisions to date on anticipated revenue streams, as illustrated in the following table:

Table 1: Recent regulatory decisions - revenue at stake

			Estimate of gross revenue (NPV$bn)		Difference	
Regulator	Business	Date	Business proposal	Regulator decision	NPV$bn	(%)
ORG	Victorian distribution	2000	12.7	11.0	1.8	14%
ACCC	EAPL	2000	1.0	0.7	0.3	33%
ACCC	SACL	2001	2.8	2.3	0.5	18%
IPART	AGLGN	1999	4.1	3.5	0.6	14%
ACCC	Telstra PSTN	2000	6.1	4.6	1.5	25%

Source: NECG calculations based on regulatory decisions. This analysis assumes that gross revenue proposed or allowed in the final year of the regulatory period in question continues in perpetuity. Revenues are discounted using the WACC proposed by the businesses for that regulatory decision.

As this table shows, the net present value of the revenues that regulatory access decisions have varied from investor expectations is approximately $4.7 billion on the basis of the above examples alone. The decision by the Victorian Office of the Regulator General (the "ORG") with respect to Victorian electricity distribution businesses, for example, resulted in a reduction in

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8 Australian Council for Infrastructure Development.

9 Australian Council for Infrastructure Development.

gross revenue of $1.8 billion in net present value terms, compared with that proposed by the regulated firms.

The issue here is not whether the particular decisions were correct of themselves. Rather, the point is that the data highlights the very substantial gap between what regulated firms sought and presumably at least in part expected, and what regulators eventually allowed. In a more certain process, regulated firms would have had clearer reference points around which they could base their announced expectations and the gap between these and outcomes would have necessarily been smaller. In other words, even if eventual outcomes were fully justified (a proposition we do not accept), the gap itself demonstrates the highly uncertain nature of the current process.[10]

These concerns also appear rational when viewed in the light of many investors' experiences with regulatory decisions that have left investments stranded, with investors unable to recover their costs. A recent example of such a case is the experience of Freight Australia.

- Freight Australia was purchased from the Victorian Government in May 1999, with access agreements with passenger operators in place, and the possibility of an access regime for freight services foreshadowed at the time of sale. On February 2001, the Minister for Transport announced that, effective 1 July 2001, open access would be declared over Victoria's freight network infrastructure. However, the proposed access regime is inconsistent with that foreshadowed at the time of sale.

- Furthermore, the pricing principles set down under the proposed regime do not allow for recovery of the initial investment in the infrastructure in the form of a pre-payment of the lease rental (which amounts to approximately $90 million). The justification for this disallowance is that no return on capital is required for much of the rail network, because it was constructed 'decades ago', and is therefore a sunk cost.

- Another problem with the pricing principles under the proposed regime is that they are extremely vague. For example, the pricing principles allow for a margin on operating and maintenance costs set at 10 per cent or 'some other figure that the Office [the ORG] may allow'.

As a result of these uncertainties and changes in the environment in which it does business, Freight Australia, under direction from the RailAmerica board, has suspended discretionary capital expenditure in response to what it sees as a threat to its sustained viability.

Similarly, various submissions to the Victorian Essential Services Commission inquiry have identified numerous examples of regulatory decisions that have left investors unable to recover their costs of investment, to the detriment of their capacity to continue their businesses. For example:

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[10] For example, in a more certain process, investors would have no incentive to engage in "ambit" claims. In that sense, the gap itself highlights the uncertain nature of the current arrangements.

- the Australian Council for Infrastructure Development (AUSCID) submission summarises a number of examples of where regulatory decisions have impacted negatively upon investors' willingness to make further investments;[11] and

- the Melbourne Port Corporation (MPC) cites an example of a regulatory decision by the Victorian ORG not to allow MPC to recover its investment in an expansion of railway infrastructure through port charges, even though this has been the historical method of recovering such costs. MPC states that 'the consequence of the ORG disallowing this expenditure are that the MPC will not be able to generate revenue to enable the funding of an appropriate financial return on this proposed expenditure.'[12]

A further example of the problem of regulatory uncertainty adversely affecting efficient investment in infrastructure is Perth Airport's experience with regulation by the ACCC. Perth Airport applied to have its investment in a covering for a second runway approved by the ACCC under the 'necessary new investment' (NNI) rules set out in the Prices Surveillance Act 1983 (Cth). The ACCC decided that the covering was not 'new investment', and was not therefore covered under the NNI rules. The consequence is that Perth Airport cannot recover the cost of its investment through increased charges, and the investment will now no longer go ahead. Perth Airport has issued a 'notice to airmen', stopping planes larger than 737-size from landing on the runway. It is also undertaking minimal maintenance on the runway, which will eventually have to be replaced, at greater expense than would be required if a covering had been built.

2.4 The need to reduce uncertainty

If, in going forward, the regulatory regime is to avoid harmfully reducing incentives to invest through unnecessary uncertainties and regulatory risks, changes must be made to that regime.

In advocating substantial change, we start from the premise that the development of a body of precedent in regulatory access decision-making will not be sufficient to properly guide investors' expectations in a direction consistent with efficient investment.

Obviously, the development of precedent is of great importance. However, the development of precedent is a lengthy and potentially socially costly process. Moreover, as will be seen from the balance of this submission, the number of points at which the current regulatory regime allows uncertainty to exist is numerous. Precedent is likely to emerge only very slowly in respect of the full range of these points of uncertainty, and even then, may say little about how established approaches will be adjusted by regulators as circumstances alter.

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11 See AUSCID, Submission to the Victorian Department of Treasury and Finance, *Essential Services Commission*, September 2000, at Chapter 3 ('Regulatory Risk'), available at: http://www.vic.gov.au/treasury/esc/sn27.pdf

12 See Melbourne Port Corporation, Submission to the Victorian Department of Treasury and Finance, *Essential Services Commission*, September 2000, at pp. 10-12, available at: http://www.vic.gov.au/treasury/esc/sn47.pdf

The reality is that the context in which the industries at issue operate is subject to on-going, and in many instances far-reaching, change. Precedent is always better at resolving mature and relatively stable issues than at guiding regulatory adaptation to substantial change. If uncertainty is to be avoided to the largest degree possible, regulators and those they regulate need clearer guidance as to the rules of the game. Addressing each of the major points at which uncertainties now arise is, we submit, therefore the key to reducing regulatory risks to an acceptable level.

In highlighting the need to address current uncertainties, we are not suggesting that uncertainty, including regulatory uncertainty, is *per se* socially harmful. We recognise that uncertainty is part of the price of adaptability, and that a regime that completely eliminated uncertainty or even sought to do so would be as costly as it was ultimately unworkable.

Rather, the issue is to eliminate uncertainty that is not essential to adaptability—and most notably, that arises simply from the failure to:

- clearly think through the goals that regulation can and should achieve;
- recognise the constraints that information imperfections necessarily impose on regulation; and
- articulate parameters that can guide regulatory action.

It may be that circumstances when the relevant legislation was enacted were not such as to allow these issues to be addressed; if so, the intervening period has allowed enough experience and knowledge to accumulate that substantially more could be done today than was done then.

As this is done, and more specifically as clearer guidance is provided in the legislation, the level of discretion available to regulators will be more tightly limited and unnecessary and socially costly uncertainties consequentially reduced. We believe many of the draft recommendations contained in the Position Paper will be of great use in this respect. However, we also believe that a number of additional mechanisms should be put into place to further clarify the parameters within which the regime ought to work. The next four sections of this submission discuss the major recommendations contained in the Position Paper and suggest additional mechanisms designed to further reduce socially unnecessary uncertainty.

3. Reducing uncertainty: coverage of the regime

We submit that economic efficiency requires that the scope of the various access regimes under Part IIIA (whether established under the declaration procedures, by certifications or through undertakings) be confined to areas where market failure is demonstrable.

We welcome, therefore, the Commission's deliberations and recommendations regarding:

- inserting an objects clause into Part IIIA;
- certification of Commonwealth access regimes;
- tightening the declaration criteria under Part IIIA; and
- developing mechanisms for exempting investments from the operation of the access regime.

However, we also consider that there is scope to provide greater certainty in a number of areas than presently contemplated by the Position Paper.

Each of these areas is discussed below.

3.1 Objects clause

3.1.1 The Commission's position

In discussing the appropriateness of including an objects clause in Part IIIA in order to guide regulatory decision-making, the Commission states that it considers that:

> … an objects clause would help to ensure that Part IIIA is well targeted, that it provides more certainty, enhances the accountability of regulators and facilitates greater consistency in decision making.[13]

The Commission draws the conclusion that an objects clause in Part IIIA should:[14]

> - Incorporate an explicit efficiency objective reflecting both short-term and long-term considerations — in particular, recognising legitimate user/consumer interests and long-term investment dimensions; and
> - Recognise the framework role for Part IIIA.

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[13] Position Paper, p.98.

[14] Position Paper, p.102.

Accordingly, the Commission has proposed that:[15]

> Proposal 5.1 (Tier 1): Part IIIA should include the following objects clause:
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> The objective of this Part is to:
>
> (a) Enhance overall economic efficiency by promoting efficient use of, and investment in, essential infrastructure services; and
>
> (b) Provide a framework and guiding principles for industry-specific access regimes.

3.1.2 Response

Section 15AA of the Acts Interpretation Act 1901 (Cth) provides that, in interpreting a provision of an Act, a construction that would promote the purpose or object underlying the Act (whether that purpose or object is expressly stated in the Act or not) must be preferred to a construction that would not promote that purpose or object. Courts have traditionally taken the view that, where the meaning or intent of a particular provision is unclear, then it is appropriate to consider an objects clause and certain other extrinsic material to assist in clarifying the meaning and intent of that provision.

Section 2 of the Trade Practices Act states that the objects of the Act are to enhance the welfare of Australians through the promotion of competition and fair trading and provide for consumer protection. The Trade Practices Act has evolved considerably since its introduction and now includes a much-expanded regulatory focus, including Part IIIA.[16]

As a very new form of economic regulation, it is the case that there is a large degree of uncertainty regarding the interpretation of the provisions of Part IIIA. As such, reference to an objects clause may be of assistance in overcoming such uncertainty. Clearly, though, the provisions of section 2 of the Trade Practices Act are not overly helpful as they currently stand in approaching such a problem.

Generally, therefore, it may be considered appropriate to include a more specific objects clause in Part IIIA, as exists in the context of the access regime in Part XIC of the Trade Practices Act, but also in Parts X, XIA and XIAA of that Act. We welcome the emphasis of the Commission's proposed objects clause on the promotion of efficient investment. We consider that such an approach is consistent with the discussion elsewhere regarding the overcoming of concerns about regulatory risks.

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[15] Position Paper, p.102.

[16] We note that section 2 was introduced in 1995 at the same time as Part IIIA of the Act, in apparent recognition of the need for an overall objects clause concerning the operation of the Act. By referring to the "welfare of Australians" rather than, say, the "welfare of consumers" (or similar), this clause has arguably sought to establish a balance between the interests of producers and consumers in relation to the objectives of the statute.

Notwithstanding our general support for the approach proposed, it is considered worthwhile drawing attention to the following considerations that we recommend be taken into account:

- as the Commission has recognised, the inclusion of an objects clause does not, of itself, operate as an effective constraint on the interpretation and implementation of regulation. This can be observed from the experience to date in the inconsistent application by the ACCC of the criteria set out in the objects clause under Part XIC of the Trade Practices Act in declaration, undertaking and pricing decisions under that Part. This is an unavoidable outcome in view of the circumstances that objects clause must necessarily be very general. As can be seen from the range of comments received by the Commission on this issue alone, there is a very large range of interpretations that may validly be placed upon general expressions of objectives. Accordingly, the inclusion of an objects clause in Part IIIA should not be seen as a panacea to problems of interpretation and consistency of interpretation; and

- overcoming this problem demands that any objects clause in Part IIIA should be buttressed by:

  - a significant tightening of the provisions of Part IIIA itself, and particularly the declaration criteria themselves, in order to avoid the need to resort to an objects clause in order to aid understanding and assist in decision-making; and

  - significant explanation of the intent and purpose behind the objects clause in the Explanatory Memorandum accompanying the relevant legislative amendment (as discussed by the Commission). Furthermore, such additional material needs to be reconcilable with the original statements of intent and purpose contained in the Explanatory Memorandum accompanying the Competition Policy Reform Act 1995 (Cth) which introduced Part IIIA into the Trade Practices Act.

    If the two sets of explanation regarding intent and purpose are not wholly reconcilable, there will be significant scope for inconsistency to occur, thus increasing the costs associated with the regime and regulatory risk and uncertainty generally. Were this to occur, the purpose of an objects clause would be defeated.

    In view of the potential scope for error in undertaking the task of drafting the Explanatory Memorandum, we consider that the Commission should focus on the approach of tightening the provisions of Part IIIA itself to overcome the need to rely solely upon an objects clause.

3.2 Certification of Commonwealth regimes

3.2.1 The Commission's position

The Commission considers that it would be desirable for all industry-specific access regimes to be tested against the Part IIIA framework through the certification mechanism. In discussing this issue, the Commission comments that:[17]

> While divergence between access regimes to cater to the particular circumstances of different industries is appropriate, the growth of an entirely *independent* family of Commonwealth access regimes should be discouraged.
>
> Given the broad nature of the Clause 6 principles, the current Commonwealth industry regimes would probably meet the criteria for certification. Nevertheless, the assessment process would help to ensure that the regimes only diverged from Part IIIA where industry-specific circumstances made this absolutely necessary. It might also help to identify anomalies in the current arrangements.
>
> At a minimum, the immunity from Part IIIA enjoyed by Commonwealth regimes should be removed. This would mean that their effectiveness could be tested in the event that a person sought declaration of a service covered by such a regime. This would provide parallel treatment with State and Territory regimes.
>
> However, as access is typically more easily secured under these Commonwealth regimes than under Part IIIA, the prospect of a declaration application may be remote. Consequently, the Commission considers that the Commonwealth should be required to submit all of its regimes for certification. While this would be a tougher requirement than that applying to the States and Territories, it seems reasonable for the Commonwealth to adopt a leadership role on this matter.

Accordingly, the Commission recommends that:

> Proposal 7.1 (Tier 1): The Commonwealth Government should be required to submit its industry access regimes for certification. For existing Commonwealth regimes, any immunity from Part IIIA should be removed.[18]

3.2.2 Response

We welcome the Commission's proposal for certification of Commonwealth access regimes.

As NECG's initial submission pointed out, a major deficiency in the scope of the Part IIIA regime is the failure to provide for certification of Commonwealth access regimes or to require that all Commonwealth access regimes conform to the principles in Clause 6 of the Competition Principles Agreement in the manner in which State and Territory regimes must conform before

[17] Position Paper, p.171.

[18] Position Paper, p. 171

they may gain protection from declaration applications.[19] If Commonwealth access regimes were required to conform more closely to Part IIIA, it is unlikely that the regulatory overreach that characterises regimes such as Part XIC of the Trade Practices Act (telecommunications specific access) would have developed.[20]

It is important to note, however, that, even if the recommendation to require certification of Commonwealth regimes is accepted, this may be insufficient to constrain the growth of Commonwealth access arrangements that are inconsistent with the provisions of Part IIIA.

We note that the only sanction associated with a failure to achieve certification is the possibility that the services in question can still be declared under Part IIIA. This is an effective deterrent for governments planning to implement regimes that are more light-handed than Part IIIA. However, it is plainly ineffectual as a means of limiting the scope for governments intent on implementing much more heavy-handed regimes, such as Part XIC of the Trade Practices Act or the Airports Act.

Consequently, we submit that the Commission should propose amendments to the certification procedures flowing from Clause 6 of the Competition Principles Agreement such that, in addition to requiring certification of Commonwealth access regimes, mechanisms are introduced that limit the extent to which all governments can put in place access regimes that are more onerous than Part IIIA.[21] Two possible such mechanisms are:

- a show cause provision, whereby all governments – State, Territory and Federal – are required to provide detailed reasons as to why an access regime diverges from Part IIIA and when convergence with Part IIIA will be achieved; and

- a provision that allows an access provider to lodge an undertaking under a reformed Part IIIA, which protects it from declaration under alternative Commonwealth or State and Territory regimes.

Introducing mechanisms such as these, and thus exposing such regimes to assessment under the Part IIIA criteria, would ensure that there is a consistent application of access regulatory policy across Australia. At the same time it would, where differences are considered appropriate, allow for greater scrutiny of the claimed justification to occur. Additionally, assessments could more easily be made over time of the continued justification for such different treatment.

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19 Network Economics Consulting Group Pty Ltd, *Submission to the Productivity Commission Inquiry into Part IIIA of the Trade Practices Act 1974 and Clause 6 of the Competition Principles Agreement*, 18 January 2001, 14.

20 A conclusion that is consistent with the Commission's own recommendations with respect to Part XIC and the need to reform that Part such that it is more consistent with Part IIIA. See: Productivity Commission, *Telecommunications Competition Regulation*, Draft Report, March 2001, pp.8.23-8.24.

21 As State and Territory governments privatise more public assets, this asymmetry in the certification process is increasingly likely to be a problem at the State and Territory as well as Commonwealth level.

3.3 Reform of the declaration and certification criteria

The initial NECG submission to the Commission suggested that the declaration criteria were broadly sensible, and did not require fundamental reconsideration. In this submission, we respond to the Commission's recommendations for reform of the declaration criteria in Chapter 6 of its Position Paper. We also respond to the Commission's proposals for reform of the criteria for certification of access regimes in Chapter 7 of its Position Paper.

3.3.1 The Commission's position – declaration criteria

The Commission has suggested that there are some deficiencies in the current declaration criteria that could lead to inappropriate declaration of services, including:

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

The Commission has recommended:

> Proposal 6.1 (Tier 1): 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.'
>
> s 44G(2)(b) be amended to: 'that it would be uneconomic for anyone to develop a second facility to provide the service.'

These proposals reflect the Commission's belief that a service should not be declared unless there would be a marked effect on the degree of competition and its view that there is no case for promoting access where, the access seeker aside, the only benefit would be to overseas consumers in the form of lower prices for Australian goods or services (such that the current 'whether or not in Australia' qualification to criterion (a) should be removed).

The Commission is of the view that declaration should, as far as practicable, be confined to essential infrastructure facilities involving natural monopoly technologies. However, the Commission has not proposed any substantial modification to the 'uneconomic to duplicate' test of criterion (b) on the basis of its concerns about the difficulty in defining the characteristics of natural monopoly in words that are both legislatively and judicially meaningful, and on the basis that the evidence before the Commission indicated to it that the 'social interpretation' adopted by the Tribunal should have the effect of confining coverage to natural monopoly technologies in any event.

The Commission also advanced a number of proposals for a more fundamental restructuring of the criteria, but sought further input about the potential costs and benefits of such modifications. The proposals are:

> Proposal 6.2 (Tier 2): For a service to be declared under Part IIIA it must meet all of the following criteria:

(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.

The Commission has developed these proposals as a means of ensuring that:

- declaration only occurs when the *service* is of significance to the national economy, rather than being derived from a 'nationally significant facility';
- declaration only occurs after demonstrating that the service provider is in a position to exercise substantial market power; and
- declaration only occurs if it would promote economic efficiency 'significantly'.

3.3.2 The Commission's position – certification criteria

The Commission has also proposed a number of 'Tier 2' changes to the criteria for certification of access regimes. These are as follows:

Proposal 7.4 (Tier 2): The certification provisions in Part IIIA should specify that an effective access regime must include:

- An objects clause;
- Coverage arrangements that focus mainly (though not necessarily exclusively) on services for which the entry to the market of a second provider is unlikely to be economically feasible;
- Clearly specified dispute resolution arrangements and provisions to establish the terms and conditions of access;
- Clearly specified criteria and pricing principles applying to regulated terms and conditions;
- Cost-effective appeal and enforcement provisions;
- Revocation and review requirements for all determinations under the regime; and

- Where appropriate, provisions to facilitate consistency across multiple State and Territory access regimes applying to a particular service.

The Commission has also suggested that the principles used to assess the effectiveness of existing access regimes for the purposes of certification should be included in Part IIIA. The proposals listed above reflect the Commission's views, amongst others, that:

- the objective of an access regime is to promote the efficient use of, and investment in, essential infrastructure facilities; and
- the criteria for certification should provide enough latitude to cater to the particular circumstances of a specific access regime, where market power derives, not from natural monopoly, but from other factors, such as network effects and high sunk costs (despite the existence of more than one provider).

3.3.3 Response

We support the Commission's proposal to strengthen the criteria for declaration and certification to ensure that inappropriate mandating of access to services does not occur. Our reasons for this view are addressed below.

Reform of the declaration criteria

We support the broad thrust of the Commission's Tier 1 and Tier 2 proposals for reform of the declaration criteria. However, we are concerned that such amendments may undermine the efficacy of recent court and Tribunal precedent that is at last bringing some clarity to the meaning of the declaration criteria. We recognise that this precedent now contains some elements that are themselves problematic, notably with respect to the interpretation of the "uneconomic to develop" test. It would nonetheless be highly desirable for the Commission to explore the potential for its proposed changes to introduce additional uncertainty.

Having expressed this caution, we observe, however, that the declaration criteria have only been in place for a limited period of time, and there is still very little precedent to upset. For this reason, it is suggested that the overwhelming consideration at this stage of the development of policy on the future of Part IIIA should be the need to ensure that the declaration criteria are correct and producing sensible outcomes.

Reform of the certification criteria

We endorse the Commission's view of the core matters that should be included in certification criteria. However, we believe that the Commission's discussion of the importance of confining declaration to areas of demonstrable market failure should apply equally to the principles for certifying access regimes under Part IIIA.

As the Commission itself noted, there are inconsistencies between some of the Clause 6 certification principles and their counterpart criteria in Part IIIA. We consider, however, that adoption of the Commission's initial recommendations for reform of the declaration criteria will

create even greater differences in the criteria for declaration and certification, and, in our view, this is undesirable for two reasons:

- greater uniformity in the drafting of the access criteria will introduce greater consistency in the regulation applying to essential facilities, and will greatly enhance the usefulness and universality of precedent developed within each regime; and

- furthermore, the greater economic significance of certified access regimes compared with declared services means that it is far more important to get the certification criteria right, ensuring that certified regimes also only apply to instances where there is demonstrable market failure.

Therefore, we submit that the Commission's recommendations attempt to reconcile more closely any differences in the certification and declaration criteria, using the principles developed in its discussion of the declaration criteria as a starting point. Table 3 summarises the differences in the criteria for certification and declaration, with the Commission's proposed additions shown in bold type and proposed deletions in strike-through script. It is immediately apparent that the important differences between the declaration and certification criteria will be exacerbated. We believe that these differences should be removed if possible.

Table 2: Differences in the declaration and certification criteria

Declaration criteria	**Certification criteria**
Access (or increased access) would **lead to a substantial increase** in ~~promote~~ competition in at least one market ~~(whether or not in Australia),~~ other than the market for the service.	Access to the service is necessary in order to permit effective competition in a downstream or upstream market.
It would be uneconomica~~l~~ for anyone to develop **a second** ~~another~~ facility to provide the service.	It would not be economically feasible to duplicate the facility.
The **service** ~~facility~~ is of ~~national~~ significance **to the national economy**, ~~having regard to (i) the size of the facility; or (ii) the importance of the facility to constitutional trade or commerce; or (iii) the importance of the facility to the national economy~~ **and the entry of a second provider of the service would not be economically feasible.**	The access regime should apply to services provided by means of significant infrastructure facilities. **It must contain coverage arrangements that focus mainly (though not necessarily exclusively) on services for which the entry to the market of a second provider is unlikely to be economically feasible.**
No substitute service is available under reasonable conditions that could be used by an access seeker.	No equivalent criterion.
Competition in downstream markets is insufficient to prevent the provider of the service from exercising substantial market power.	No equivalent criterion.
Addressing the denial of access, or the terms and conditions of access, to the service concerned is likely to improve economic efficiency significantly.	No equivalent criterion.
Access (or increased access) to the service would not be contrary to the public interest.	No equivalent criterion.

3.4 Mechanisms for exempting investments *ex ante*

We believe that, in addition to reforming the declaration criteria, regulatory risk can be further reduced if procedural reforms are required that will allow a potential investor in infrastructure, prior to the final commitment of funds, to obtain advice from the relevant regulator as to whether or not the infrastructure will likely be subject to a regulated access regime.

In many other parts of the Trade Practices Act for example, as well as in other bodies of law and administrative practice, provisions exist that allow firms to obtain some certainty as to whether or not a proposed arrangement, acquisition etc will likely breach the Trade Practices Act and obtain a degree of certainty as to whether the proposal can proceed without adverse intervention by the ACCC (for example, authorisations, notifications and informal merger clearances).

Similar provisions should be an integral part of Australian access regimes. We submit that a system of regulatory safe harbours be implemented that involve an advisory decision being made by the regulator (for example, the NCC), before investments are committed, as to whether or not

the proposed investment will be declared once the investment is made. That decision would be binding for the life of the asset, but subject to a "material change in circumstances" clause.

Specifically, a process akin to the authorisation/notification and informal merger clearance procedures operating under the Trade Practices Act at present could be implemented whereby:

- a prospective investor could request a binding opinion from the NCC as to whether or not the criteria for declaration are satisfied in relation to a proposed investment;
- the NCC would then be obliged to consider that request and issue either:
  - an opinion as to whether or not the declaration criteria are so satisfied; or
  - 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 investor; and
- any opinion provided by the NCC would be binding on the NCC in any future application for declaration of the asset except where a court can be persuaded that:
  - information provided to the NCC by the prospective investor was, at the time it was provided, inaccurate or reasonably ought to have been known by the investor to be inaccurate; or
  - there has been a *material* change in circumstances in the intervening period, the onus of proof of which is on the NCC.

The objective of such a process is to provide a degree of certainty *ex ante* as to whether the investment may fall within the scope of the access regime. The above proposal recognises, however, that it would be inappropriate to expect a regulator to bear all risks over the life of the investment. Accordingly, this proposal allows for a reconsideration of the original decision where there has been a material change in the market conditions within which the investment operates (for example, the firm providing the major competitive constraint operating on the facility exits the market.) Obtaining this guarantee before the investment has been made has two distinct advantages that should help to facilitate the promotion of efficient investment:

- safe harbour procedures provide investors with much greater certainty than the current system (which provides no certainty *ex ante* at all) as to the scope of the relevant access regime. This reduces the riskiness of the investment and hence the costs of capital; and
- by more closely aligning decisions on regime coverage with decisions on whether or not to invest (instead of having regulatory decisions made after the funds are committed) safe harbour procedures would act as a significant deterrent to regulatory creep. Regulators' incentives and willingness to unduly extend the scope of regulation would be significantly diminished if the costs of that over-extension, in terms of reduced investment, were immediately felt. By locating the declaration decision at a time when the asymmetry in negotiating power between the regulator and the regulated entity is less marked, the safe harbour process would reduce the likelihood of over-extensive regimes.

3.5 Access holidays

3.5.1 The Commission's position

The Commission noted that there is a strong 'in principle' case for providing investments in essential infrastructure that are expected to be only marginally profitable with some immunity from exposure to access regulation. The Commission recognises that, without a degree of immunity, such investments may be deterred, denying the community the opportunity to benefit from the availability of new or improved services.

The Commission has discussed the implementation of 'access holidays' as one possible countermeasure to such undesirable outcomes. It has suggested that access holidays could be implemented through a form of 'null undertaking' that specifies no regulated access would be provided to the service in question for a designated period.

The Commission has sought advice as to how long access holidays would need to be and what criteria would be used to select projects in respect of which it would be appropriate to grant such an access holiday.

3.5.2 Issues with access holidays

Whilst we welcome the Commission's recognition that some form of immunity from access regulation is appropriate for certain investments in essential infrastructure, we are not convinced that access holidays are the best way in which to approach the underlying problem.

Some of the difficulties associated with access holidays include that:

- they could be used as a mechanism for avoiding the broader reforms necessary to ameliorate the negative impact that current regulatory practice has on incentives for efficient investment;
- if an access holiday can be justified in respect of a particular facility, then serious questions need to be raised about why the facility in question was eligible for declaration in the first place. This is particularly the case given that the Commission appears to be focusing its proposal narrowly on marginal greenfields investments;
- while the Commission has focused narrowly on greenfields investment, such investment, though important, is swamped in dollar terms by investments in upgrades, extensions and maintenance of existing facilities. This narrow focus means that the proposal will have limited impact in broader economic terms;
- since access holidays are time delimited, their utility in achieving the objectives claimed for them is questionable. Many investments – particularly greenfields investments – are characterised by total revenues well below costs in the early years. It is only if and when the 'blue sky' arrives that many investments make a positive return for investors. Typically, however, access holidays operate during the loss-making period – when demand for access is low in any case – and then run out when the investment is proved and access seekers want to share in the blue sky; and

- finally, there are likely to be significant administrative issues in distinguishing between what is and what is not eligible for a holiday and how long the holiday will last. For example, with the former there will be significant administrative issues involved in determining what is a new investment and what simply represents an extension or upgrade of the network. Evidence from the airport procedure on necessary new investments indicates how regulatory intervention can distort decisions as between greenfields investment and expansion/renewal investments. Overcoming these issues is likely to require the implementation of overly intrusive regulatory mechanisms and processes, at not insignificant cost.

3.5.3 Alternative mechanisms

In addition to access holidays, we would ask the Commission to consider the scope for the introduction of a number of mechanisms that address directly the specific issues that are raised by greenfields investments and other investments that are particularly risky. Some risky investments will be successful, but others are likely to fail. Regulation becomes an issue when returns for successful projects are truncated by regulation at the cost of capital for the project (because no symmetric regulatory action can or does turn failed projects into successes). Successful projects need to return more than the cost of capital to offset the losses associated with projects that are not so successful so that, for the industry as a whole, all projects of comparable risk return the cost of capital.

Regulatory mechanisms employed thus far to manage particularly risky investments fail to address the real issues. For example, in the case of the Central West pipeline, a higher cost of capital was assumed by the ACCC (for price determination) and a longer period between regulatory resets (10 years) was offered to address the issues outlined above. However, the reality is that the viability of this project depends on significant regional growth (even if all the existing potential market connected to gas today the project would fail) and the market determines the prices that can be charged. The project will not recover over the next 10 years anywhere near the amount that would be allowed through normal regulatory processes. In other words, there is no need for regulation of this project in the foreseeable future (the market will do that) and the proposed ‘extended’ regulatory period does nothing to reduce risk.

We do not think an access holiday provides the answer for investors concerned about regulatory risk. Any holiday that would remove the risk that the returns for successful projects may be truncated by regulatory intervention would have to occur towards the end of the project, not at the beginning of the project (when returns are below the cost of capital).

Instead, we suggest that the Commission consider the scope for regulated firms to be given some assurance *ex ante* that the additional risks they are bearing will be reflect in regulated access prices. We reiterate here, two potential approaches for the Commission to consider: the Petroleum Resource Rent Tax approach and the pre-investment agreement approach.[22]

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[22] These approaches are also briefly discussed in section 4.7 of this submission.

The Petroleum Resource Rent Tax (PRRT) approach

The PRRT applies to offshore petroleum exploration and production. Under this approach, a RRT is not imposed until such time as the net present value ('NPV') of the project, discounted by a factor equal to the relevant cost of capital, is positive. The discount rate (or cost of capital) employed in PRRT is the Commonwealth Long Term Bond Rate (LTBR) + 15 per cent for exploration expenditure, and the LTBR + 5 per cent for other expenditures.

Once the project is NPV positive, the PRRT is levied at 40 per cent.

We suggest that the same approach could be applied to greenfields investments.[23] Price regulation would not apply until the NPV of the greenfields project, discounted by a factor equal to the relevant cost of capital, is positive. If the project becomes NPV positive then the sharing of benefits would be distributed 60 per cent to owners and 40 per cent to users.[24] This approach would ensure that returns on successful projects would not be truncated at the cost of capital, thereby allowing some 'blue-sky' to offset the losses on projects that are not so successful. This would provide a more favourable environment for entrepreneurial investments.

The pre-investment agreement approach

In addition, we suggest that procedures could be introduced to allow the investor to obtain increased levels of certainty prior to the investment being made on how access prices will be determined.

One option for investors who require greater certainty *ex ante* would be a requirement for an explicit regulatory contract between the regulator and the regulated firm. The terms of this contract would be agreed upon prior to the regulated firm making an investment in assets that the safe harbour process, noted above, indicates are likely to be subject to regulated access requirements under Part IIIA. Such *ex ante* agreements will allow the regulated firm to undertake more precise financial modelling with a view to making the final decision on whether or not to proceed with the investment. Regulatory contracts could take one of two distinct forms:

- a compact between the regulator and the regulated firm on the key regulatory parameters – that is, *ex ante* agreement on the parameters in the regulatory model that are determined by the regulator such as the beta weights to be used when calculating the weighted average cost of capital, whether or not assets will be vulnerable to regulatory stranding (that is, a cost optimisation modelling approach used), and if so the circumstances under which this would occur (i.e. how the optimisation would be

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23 While exploration is more risky than most greenfields infrastructure projects, they do share the common elements of discrete investments with high risk.

24 A 60:40 is the established sharing ratio for offshore exploration and production under the PRRT. We suggest it would be reasonable to adopt the same ratio for risky infrastructure projects. While we recognise that there are economic issues involved in determining the efficient degree of sharing, we believe that the implicit mark-up involved in a 60:40 split is not out of line with a slight (10-15%) real option value to deferring investment.

implemented), the period between regulatory resets and so forth. The regulator will be bound to agree to parameters that are proposed and that are consistent with the legislative pricing principles, subject to a strict material change in circumstances clause;[25] or

- an undertaking, which would detail the terms and conditions of access for the lifetime of the asset. Again, the regulator will be bound to agree to an undertaking that was consistent with the legislative pricing principles, subject to a strict material change in circumstances clause.

Were undertakings to be employed, they would need to be administered to reflect the commercial and time sensitivities of investment planning and future access requirements. Undertakings should take the form of streamlined market inquiries rather than the unwieldy processes that, to date, have characterised undertakings under Part IIIA.

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25 We have proposed earlier that a number of these elements, for example *ex ante* determination of the cost of capital and risk components, be adopted in respect of all investments, not simply for risky investments.

4. Reducing risk: access terms and conditions

In Section 2, we argued that current regulatory risk is a deterrent to appropriate investment.

In Section 3, we suggested measures to improve economic efficiency and reduce regulatory risk. These measures included unifying Australia's approach to access regulation, limiting the reach of that regulation to areas where market failure is demonstrable, and providing means for investors to ascertain (prior to making an investment) whether their investment will be subject to access regulation.

In this section, we respond directly to the Commission's proposed pricing principles, which we endorse with some minor modifications. We then go on to comment that there are significant problems involved in the current models that are widely used to determine the regulated terms of access.[26] These problems greatly increase the risks investors in regulated assets are forced to bear. In our view, significant changes are needed in the way access terms and conditions are determined if incentives for efficient investment are to be maintained and strengthened. We illustrate two incentive-based models as potential alternatives to the current approaches to access pricing. We also reiterate the need for specific mechanisms to provide some certainty *ex ante* for risky investments.

It is important to note at the outset that Australian access regulation is characterised by a plurality of approaches to the determination of access terms and conditions – some industries, for example, are subject to negotiate/arbitrate models, others are subject to what is essentially rate of return regulation. In spite of the significant differences between the various regulatory environments, we have identified in this section of our submission a common thread of issues important to the broad range of firms and associations that are signatories to this submission.

4.1 The Commission's position

The Commission made the point that clear specification of objectives is fundamental to all forms of regulation. It also observed that the legislation giving effect to the national access regime does not embody an overarching objects clause.

In addressing the possible content of an objects clause, the Commission indicated that a number of participants had expressed concerns about perceived tensions between:

- the different interests of users and facility owners;
- efficient use of infrastructure and efficient investment;
- short-term versus long-term efficiency considerations; and

[26] The current models can generally be characteristed as building block approaches based upon regulator assessments of efficient costs.

- static versus dynamic gains.

The Commission concluded that the appropriate balance between these concerns is that Part IIIA must seek to promote efficient use of essential infrastructure, but in a way that does not discourage efficient investment and, if tension existed, ‘it is appropriate to lean towards ensuring that long-term efficiency is not jeopardised’.

Taking the above into account, the Commission concluded that Part IIIA should include an objects clause and that it should incorporate an explicit efficiency objective reflecting both short-term and long-term considerations and recognise the framework role for Part IIIA (in the context of industry specific access regimes) as follows:

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

The Commission points out that meeting these objectives is dependent on the criteria which govern the crucial matter of access pricing (including the efficient use of and investment in infrastructure).

In Chapter 5 of the Position Paper, the Commission notes that the current criteria set out in section 44X of Part IIIA do not give practical guidance to the regulator on the pricing of access and recommends that the following pricing principles be inserted into Part IIIA:

> Proposal 8.1 (Tier 1): The pricing principles in Part IIIA should specify that access prices should:
>
> (1) Generate revenue across a facility’s regulated services as a whole that is at least sufficient to meet the efficient long-run costs of providing access to these services, including a return on investment commensurate with the risks involved;
>
> (2) Not be so far above costs as to detract significantly from efficient use of services and investment in related markets;
>
> (3) Encourage multi-part tariffs and allow price discrimination when it aids efficiency; and
>
> (4) Not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, unless the cost of providing access to other operators is higher.

4.2 Response

As noted above in section 3.1, we endorse the recommendation to insert an objects clause into Part IIIA, and we also endorse the specific clause proposed (and suggest that the intent of the objects clause be expanded upon in any Explanatory Memorandum that might accompany a Bill to implement changes to Part IIIA).

We also agree with the general thrust of Proposal 8.1. In our view, it is an appropriate response to the issue of under-investment described in the Position Paper, and is clearly designed to achieve the objectives of Part IIIA enunciated in the proposed objects clause. We are concerned, however, that:

- the term 'efficient long run costs' could be ambiguous and could either require precise assessments of firms' actual costs (including forecasts) or alternatively bear no relationship to firms' actual costs;

- Proposal 8.1(1) could be (wrongly) interpreted to mean that access revenue should 'guarantee' a return equal to the cost of capital (which would cut across the objective to promote efficient use of infrastructure). For example, we would not wish Proposal 8.1(1) to be interpreted as allowing (much less mandating) rate-of-return regulation; and

- the test set out in Proposal 8.1(1) could be met even if the access prices for some services were set below long-run incremental costs. More specifically, the test as articulated refers only to the comparison between costs and revenue from the *combination* of regulated services. However, and additionally to the test as set out in that proposal, efficiency will generally require that no individual access price be set below a floor defined by incremental costs.[27]

For reasons which are discussed below, we suggest that the phrase 'efficient long run costs' should be replaced by 'costs prudently incurred'[28] and that Proposal 8.1(1) should be modified to capture the intent that access providers should have a reasonable expectation that they will be able to recover costs prudently incurred (including the cost of capital) while still being exposed to normal market risk.

Having endorsed the objects clause and the pricing principles in Proposal 8.1 (with modification) we must, however, point out that these proposals will not, by themselves, provide the environment in which investors can do their part to achieve the objectives of Part IIIA. Existing regulation exposes investors to excessive regulatory risk. For example, current practice relies upon precise estimates of firms' costs, even though regulatory decisions are subject to substantial informational uncertainty. Since investors must be compensated for bearing this risk, reducing regulatory risk — and there is considerable scope to do so — will reduce investment costs and, hence, foster efficient long-run service provision. Excessive regulatory risk is a significant source of inefficiency. We suggest that additional principles and rules, discussed below, should be

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[27] The only exceptions to this rule are when the regulated service is complementary to another service but more price elastic that that other service. For example, it may in some cases be efficient to set the variable component of a two-part tariff below the relevant incremental cost if doing so increases payments of the fixed charge.

[28] As discussed below, we would expect that, under properly structured incentive-based regimes, actual costs would closely approximate efficient costs or 'costs prudently incurred' because the firm would have the incentive to ensure the prudency of all expenditure decisions. In contrast, we also suggest below that attempts by regulators to ascertain the prudency of particular expenditure decisions involve processes that are fraught with difficulty and that dramatically increase the risks faced by investors.

embraced to complement the objects clause and the pricing principles in Proposal 8.1. Without them, we suggest that the objectives that motivated the principles in Proposal 8.1 will not be achieved.

4.3 Regulatory uncertainty and risk

Under most current approaches to access regulation in Australia, the following regulatory risks are routinely encountered by investors, substantially increasing the costs of investment in regulated services:

- the risk that regulators will strand investments, thereby removing the possibility of recovering investment costs (the optimisation issue), even when the investments were deemed efficient at the time;
- the risk that regulators will not allow the firm to recover legitimate operating costs (the efficient cost issue);
- the risk that arises because key parameters that regulators establish, such as the allowed return on assets, are not known at the time investments are made;
- the risk that as market risks reduce over time, regulators will reduce the allowed return on assets, even though the risks at the time of the investment were higher; and
- specific risks which arise in relation to 'greenfields' or other particularly risky projects.

We will discuss each of these, particularly pointing out the ways in which they conflict with the proposed pricing principle in Proposal 8.1 and the proposed objects clause.

4.4 The risk of stranding capital costs and operating costs

Whatever its precise form, a common feature of access regulation in Australia is that it leaves open to the regulator the ability to strand part or all of an asset if market circumstances have changed, or if changes in technology would result in a different investment today (stranding through optimisation). We contend that the threat of such asset stranding, if it is not properly compensated for, must deter investment, and is therefore inconsistent with the proposed objects clause. The extent of the risk involved, and the likelihood of its deterring investment, is made all the greater by the informational uncertainties inherent in attempting to derive optimised costs.

In addition, the current approach to access regulation, which bases access prices on the regulator's assessments of efficient operating costs, can result in properly incurred costs remaining un-recovered because of mistakes in assessing efficient costs.

The Commission has recognised these informational uncertainties faced by regulators and has suggested that Australia should perhaps 'scale back' its ambitions for access regulation:

> … the extensive information required to base access prices on precise assessments of firms' costs, and the attendant risk of mistakes, might provide a case for less intrusive approaches, involving some rules of thumb.[29]

Furthermore:

> These considerations suggest that regulators should not be too ambitious in their approach, and that governments should not place too great a level of expectations upon them. A sensible goal is to improve on unregulated outcomes, but recognise that precision is not possible with the information and instruments available.[30]

We agree with the Commission's assessment. Attempts by regulators to determine efficient capital or operating expenses under the rubric of the building block approach to determining access prices are overly ambitious and, under a properly designed incentive-based system, unnecessary.

4.4.1 The risk of asset stranding - the 'optimisation' issue

Under the current approach to regulation in Australia, it is open to a regulator to apply '20-20 hindsight' to strand part or all of an asset if market circumstances unforeseen at the time of investment have changed, or if changes in technology would result in a different investment choice today than at the time of the actual investment.

For example:

- telecommunications pricing is set so as to offer the service provider the opportunity to earn a return on an investment, the value of which is equal to the cost of a notional optimised asset. Rapid improvements in technology then translate into a value significantly below the asset's reproduction cost. Unless economic depreciation is allowed and secured, this imposes a capital loss on the asset owner; and

- the National Third Party Access Code for Natural Gas Pipelines explicitly allows a regulator to strand assets through an optimising approach to asset valuation.

In relation to electricity distribution in Victoria, the situation was uncertain until the Office of the Regulator General stated that it would not strand investments that were considered prudent at the time of installation.

From an investors' point of view, for any given degree of optimisation, a central issue is the income consequence of that optimisation and, in particular, the extent of the stranding risk to which the entity is exposed. We submit that the concept of investment optimisation is theoretically questionable and that in practice it results in substantial regulatory uncertainty with a consequent adverse impact on investment incentives.

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[29] Position Paper, p.71.

[30] Position Paper, p.207.

Limited arguments for optimisation

Exposing the regulated entity to stranding risk is conventionally justified in terms of the desirability of ensuring a sequence of outcomes that could prevail were the market contestable. This argument is unconvincing, in that it abstracts from the defining feature of a contestable market (namely, the absence of significant sunk costs), whereas in such markets no stranding risk arises. No valid inferences can be drawn, at least in any simple way, from the workings of contestable markets to those of markets where economic behaviour is shaped by the existence of substantial sunk investments. Unless a regulator is prepared to countenance the myriad other adjustments to regulated prices necessary to more closely align such prices with those that would prevail in a contestable market, all optimisation does is provide a windfall loss to investors with consequent impacts on investment incentives.

A more plausible account of the argument for exposing the regulated entity to stranding risk is that it is intended to prevent consumers from paying costs associated with monopoly inefficiencies.

In considering this argument, it is useful to start by noting that an unregulated monopolist need not be technically inefficient.[31] While complex arguments can be mounted as to why a monopolist might be less efficient in a static productive efficiency sense than a competitive firm,[32] powerful counter-arguments can be put pointing the other way. Nor is there any *a priori* reason to believe that a firm exposed to competition will innovate at a more socially efficient rate than one that is not so exposed.[33]

Even if monopolists could be shown to be inefficient, this would be sufficient only to justify the imposition of a prudency test on regulated firms. In a prudency test, the central issue is whether the investment was optimal when it was made; in contrast, in an optimisation approach, the central question is whether the investment is optimal at the date of the assessment. Even if there were legitimate concerns about monopoly inefficiency, a prudency requirement would address those concerns without allowing regulators to impose the wisdom of hindsight on the remuneration for risk bearing.[34]

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31 Obviously, there is no presumption that a monopolist will produce at the point where average costs are minimised—indeed, this will occur only by chance. But this does not mean that at its chosen scale of output, the monopolist will incur higher costs than are socially warranted for that scale of output.

32 The most convincing of these arguments have to do with the ability of the owners of a competitive firm to rely on industry benchmarks in contracting with managers, thus reducing agency costs.

33 It is surely striking that in all the major anti-trust cases that have concerned firms close to being monopolies – Standard Oil, Alcoa, United Shoe Machinery, du Pont (for cellophane and titanium dioxide), IBM and most recently Microsoft – the complaint has been not of too little innovation, but rather of innovation so sustained and targeted as to exclude potential rivals.

34 In practice, a regulator should allow a firm to recover its CPI-adjusted historic costs (if those costs are considered prudent) with economic depreciation used to capture technological obsolescence.

Adds to the extent of regulatory uncertainty

In addition to these concerns about its analytical bases, in practice optimisation is a particularly complex exercise for which there is no legislative guidance. The process generally requires the development of a detailed and comprehensive bottom-up network-engineering model based on best-in-use technologies and operating practices.[35] These models require regulators to make literally hundreds of assumptions, many of which will never be tested. When conditions are changing rapidly — for example, with the introduction of a new best-in-use technology — the model and its underlying assumptions needs to be constantly revised. In addition, the development of such models and the associated consultation period has proved to be lengthy and expensive.

In a competitive market, the market itself generates the valuations that correspond to shifts in demand and supply. However, regulators always lack the kind of information needed to simulate, even approximately, the market's performance in that respect. Indeed, as can be seen by looking at the gap between the Australian Communications Authority's valuation of Telstra's PSTN line costs and the ACCC's valuation of the same costs, different regulators can and do come to quite widely differing conclusions when seeking to determine optimised costs.

This creates uncertainty that inevitably adds to the risks investors face. Australian regulators, most notably the ACCC, have been willing to engage in optimisation on a far greater scale than their counterparts overseas. Yet they have never provided any evidence that the gains to the community from optimisation outweigh the risks the process creates. Indeed, in industries in which demand is highly inelastic, it seems completely implausible that the pattern of costs and benefits would be such as to justify optimisation.

In summary, the threat of regulatory asset stranding as part of an optimisation process creates risks that in turn increase the costs investors must bear, and hence acts as additional deterrent to efficient investment. That is, asset stranding undermines the achievement of the objectives in the proposed objects clause.

4.4.2 Risk of non-compensatory operating cost allowances – the 'efficient cost' issue

In addition to the threat of asset stranding (which affects capital costs), perhaps the principal source of uncertainty that investors face under the current approach to access regulation is the use of regulator assessments of efficient operational and maintenance (O&M) costs in access pricing determinations.

We submit that regulators face similar problems in the search for efficient O&M costs as those encountered in the optimisation of capital expenditure. Indeed, it could be argued that identification of efficient operational costs is even more difficult given the large number of expenditure items that need to be assessed by regulators seeking to ensure that monopolists are not extracting rents via higher costs.

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[35] In some instances, short cuts are used – such as limiting engineering studies to particular issues (say, whether facilities are over-dimensioned) or localities (say those where demand has declined since the date of the initial investment).

It is recognised that regulators will not usually have in-house expertise sufficient to define and cost the ongoing maintenance and operational activities required to maintain the required quality of service. Regulators are not of course without knowledge. They usually have access to past accounts and information about past trends, and they will usually have a high level knowledge of the make-up and expected lives of the various component parts of the infrastructure system. This knowledge is not, however, sufficient to enable regulators to assess or forecast operating cost requirements with the degree of precision and confidence that is necessary if detailed cost-based regulation is to be applied correctly, and the cost of a wrong decision avoided.

To overcome the information deficiencies associated with attempting to implement access pricing based upon regulator assessments of efficient costs, regulators have turned to cost benchmarking and independent expert advice. Neither approach sufficiently avoids the intrinsic difficulty in obtaining correct estimates of 'efficient' costs.

Most owners of infrastructure have little or no confidence in benchmarking approaches to efficient cost determination for use in setting regulated access prices. Vogelsang explains why this is so. He observes that regulation which makes the prices a utility can charge dependent on the performance of other firms or on some efficient benchmark "is risky for a utility to the extent that its costs differ from the yardstick by virtue of such factors as geology, climate, population density, local wage rates, taxes, or the like".[36] Experts, particularly those with only limited exposure to the firm at issue, will often lack the detailed, firm-specific, knowledge needed to correct for these differences.

In addition, there is a perception that experts may be influenced by what they perceive to be the agendas of their principals. If the principal is the owner, then experts are more likely (or are perceived as being more likely) to bend their findings to favour the owner. If the principal is the regulator, then experts are likely (or are perceived as being likely) to bend their findings against the owner.

Overall, we submit that the search for efficient operational costs by analytical means is almost certain to fail in practice given the information uncertainty facing regulators. It is, in other words, ultimately likely to prove futile and socially harmful. Additionally, it is our view that that search should be unnecessary in the presence of a properly constructed regime based on incentive regulation.

The theoretical basis of incentive based regulation is that efficient costs will be revealed through the operation of properly structured incentives – it is not necessary to seek to determine those costs by other means such as regulatory inquiry. It is relevant that while Australian and UK access regulations rely on regulator assessments of efficient costs, the US generally avoids such

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[36] Ingo Vogelsang, *A 20-Year Perspective on Incentive Regulation for Public Utilities*, ACCC Regulation and Investment Conference, Sydney, March 26-27, 2001.

Vogelsang also refers generally to the development of benchmarking approaches to estimate efficient long-run costs, and specifically to TSLRIC models which "[while they] try to include an enormous amount of local information, they will miss firm-specific peculiarities on input prices, demands etc. and therefore will not accurately measure the efficient costs of a specific utility".

estimates because of the associated vagueness and subjectivity. For example, in determining the X factor in price cap regulation, the UK approach makes assessments of the future, taking market growth, and new technical developments etc into consideration, while the US approach is more oriented to past productivity growth rates.[37]

The approach employed in Australia is identical in most respects to the UK approach. The US approach relies more on the incentives in the price cap to uncover efficient costs, and then transfers productivity that has been realised (not assessments of future productivity) to consumers. We submit that the Commission should recommend an approach such as that employed in the US and let incentive-based regulatory mechanisms reveal efficient cost levels.

4.5 *Ex ante* uncertainty as to regulatory parameters

In addition to the uncertainties arising from stranding and from regulatory disallowance of operating costs, owners and operators of declared assets are currently exposed to the risk that key regulatory parameters that bear upon their profitability and ability to maintain and improve their assets are unknown at the time of investment and will change, without warning, at several times throughout the lives of the assets.

Investor disenchantment with Australian regulation arose in part as a consequence of the year 2000 Victorian electricity decision on distribution pricing – the first reset since the government-owned assets at issue were sold. One of the key outcomes of this decision was that prices would be based on a cost of capital that was well below the figure that underpinned the prices that were stapled to the businesses at sale. Investors argued that this decision removed $1.8 billion from the value of their distribution businesses in Victoria.

While the Victorian case was, correctly or incorrectly, seen by investors in terms of a failure by the authorities to uphold undertakings that were, in the investors' views, made at the time of sale, the case also raises a general issue for all regulated investment. This issue is that at the time investments are made investors face uncertainty as to the cost of capital that will be assumed in regulated prices set initially, and also at subsequent resets.

To overcome the former problem we suggest that regulators should disclose to investors the cost of capital that will be assumed in setting access prices in the first regulatory period before investments in capital replacement, capital expansion, and in new projects are committed. This should now be possible given that we have had several years of debate on the cost of capital since access regulation was introduced. It seems reasonable that investment be guided by such disclosure.[38]

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[37] See Ingo Vogelsang, *A 20-Year Perspective on Incentive Regulation for Public Utilities*, ACCC Regulation and Investment Conference, Sydney, March 26-27, 2001.

[38] Disclosure could be achieved through:

- annual publication of the cost of capital for reference investments – eg investments in energy, water, and telecommunications in major cities; and/or

As to the uncertainty of the cost of capital to be employed in price resets, investment decisions are generally made on the assumption that the expected rate of return over the project life is at least equal to the cost of capital as estimated at the time the decision is made.[39] However, under current regulatory practice, and in some instances, as a consequence of pricing principles in access regimes, investors face the prospect that, at successive resets, prices will be determined on the basis of the forward looking project risk at the time of the reset, with the consequence that the return on a successful project may be less than the cost of capital on which the investment decision was based. If it is known pre-investment that future prices (and therefore revenue outcomes) for successful investments will be determined on the basis of conditions prevailing at each reset, investors will inevitably take this into account in their investment decisions. The consequence will be that some investments that would otherwise have been undertaken will not proceed.

To overcome this, we suggest that it should be a requirement that the risk component of the cost of capital used to determine access prices be fixed by the regulator for the life of the investment. More specifically, the regulated firm would be able to seek from the regulator, a commitment to a beta value for the calculation of the capital cost of the asset.[40]

It is important to recognise that these initiatives will not entirely address the problem set out above. Specifically, project viability typically depends not solely on the allowed or estimated cost of capital but also on the level of demand. If prices are capped when demand is high (say by being set, in those circumstances, on the basis of unit costs at a high level of output), but revenues are not guaranteed when demand is low, then even setting the cost of capital in a manner that does not depend on out-turns will discourage risky investments. Rather, there is a more general need to ensure that access prices are not being set in such a way as to "privatise losses but socialise profits". Providing some certainty with respect to the risk component of the cost of capital should therefore form part of a broader approach that recognises investment risk in determining allowed access prices.

4.5.1 Summary of inappropriate regulatory risks and suggestions for resolution

We have discussed the following regulatory risks:

- risk that regulators will stand investments thereby removing the possibility of recovering their costs (the optimisation issue);
- risk that regulators will strand operating costs thereby removing the possibility of recovering them (the efficient costs issue);

- commitment to the cost of capital for specific prospective investments.

39 Evidence can be found in post-project evaluations – projects are rated successful if they have delivered a rate of return equal to or greater than the pre-investment cost of capital.

40 We recognise that there are some risks involved in fixing the beta weights, however, amongst the investment community the general assessment is that these costs are outweighed by the conscious decisions to adjust beta weight at price resets.

- risk that arises because the regulators view of the cost of capital is not known pre-investment; and
- risk that regulators will downgrade the risk component of the cost of capital at resets to reflect the forward-looking project risk at the time.

We suggest that the first two risks listed could be minimised by modifying Proposal 8.1 to read 'costs prudently incurred' instead of 'efficient long-run costs'.

The third risk listed could be minimised by providing an entitlement for owners to know the regulatory cost of capital before capital expenditure commitments are made.

The fourth risk listed could be minimised by requiring that the risk component of the cost of capital must be fixed, at the time of investment, for the life of the investment.[41]

4.6 Illustrative alternative approaches for determining access prices

Many of the difficulties discussed above arise from regulators' attempts to determine regulated charges through a building blocks approach based upon their assessments of efficient costs, with cost optimisation being a component part of this process.

For illustrative purposes we describe two alternatives to the current approaches used to determine access prices, which address the issues of regulatory uncertainty and risk that have been identified and which are broadly consistent with the Commission's proposed pricing principles. One alternative is cost-based and the other is based on external movements in productivity. Both approaches employ a price cap and a fixed regulatory period as a means of promoting the efficient use of infrastructure, and reduce the regulatory risks that detract from the current regime.[42]

4.6.1 Alternative cost based approach

This approach employs a CPI-X price cap for setting average prices to be charged over the regulatory period. At the beginning of a review period, X is determined as the number which (if applied in the CPI-X price cap formula) will return today's (the test year) rate of return on the regulatory asset base to an appropriate level (the cost of capital) by the end of the price control period. This approach sets a regulatory price path at each reset, with the objective of gliding current prices to prices at the end of the regulatory period which would recover actual current costs (rather than estimates of 'efficient' costs) including an appropriate cost of capital.

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[41] The risks that are specific to greenfields and other particularly risky investments will be discussed later in this Section.

[42] These alternatives are clearly not exhaustive, and are not intended to imply that there is no scope for improving existing approaches. See, for example, the suggestions included in Telstra's various submissions to the Productivity Commission's current Inquiry into Telecommunications-specific Competition Regulation.

Conceptually, it is similar to the approach employed in the US and described by Vogelsang and to the approach that was used for setting gas prices for tariff users (residential and small business) in New South Wales between 1990 and 1997.

The characteristics of the model include the following:

- it employs a price cap and a fixed regulatory period (generally not less than four or five years) to provide incentives to improve efficiency;
- it is based on actual capital costs at the point of investment, not on derived estimates of efficient costs, thereby removing the risk of stranding of investments previously found to be prudent;
- it relies on the incentive properties of a price cap to uncover 'efficient' operating costs[43], thereby avoiding the risks and intrusion that necessarily arise with models that require the determination by regulation of 'efficient' costs;
- efficiency gains actually realised in one regulatory period are shared with users in the following period, thereby avoiding the transfer of efficiency not realised. The service provider retains the gains of realised efficiencies for five years, thereafter the gains transfer to users;
- the 'glide-path' employed to transfer the (future) benefits of (realised) efficiencies to users removes the tendency for incentives to decline towards the end of a regulatory period;
- an X component reflecting forecast industry TFP can be added to the base X, tightening the cap but also introducing some uncertainty;
- it leaves the service provider exposed to market risks (e.g. variations in general economic conditions, demand for services, input costs and efficiency) but removes a number of elements of regulatory risk; and
- price paths are set by reference to actual costs at resets.

This alternative approach would probably be considered to be a generous or loose price-cap when compared with today's approaches to determining access prices. In this regard we make the following comments:

- there appears to be a widespread view that any price cap that results in the service provider reaping an incentive reward was set too loosely. Policy makers and regulators seem to have lost sight of the fundamental feature of incentive based regulation and price caps, that the potential rewards of higher profits will drive the service provider to bring about improvements in efficiency. A general view seems to have formed that it is

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43 The incentive embodied in price caps with fixed regulatory periods should continuously drive actual costs towards efficient costs.

sufficient for incentive purposes to present the service provider with a cap that cap leaves no potential for returns greater than costs even when significant efficiency improvements are achieved. This may work in the short-term, but it is unlikely to sustain dynamic efficiency;

- because the alternative approach proposed here ensures that the service provider will share the benefits of efficiency improvements, it provides sustained incentive for continuous improvement. This is not true of the current approaches to access pricing for several reasons. Informational uncertainties mean that there can be no confidence that the realisation of potential efficiency improvements will result in returns that cover costs. Moreover, even if under the current approaches prices could be set correctly such that all future cost reductions were foreseen, the service provider will, by definition, not share any of the benefits of improved efficiency; and

- because the alternative cost based approach sets X by reference to factors within the control of the firm, it may be argued that it is open to the firm to extract monopoly rents via excessive costs[44]. However, any X which is set by reference to external factors, and thus removes this potential for inefficiency, will give rise to the risk that the service provider will not be able to recover its costs including an appropriate return on capital. This puts any such approach at odds with the principle proposed in Proposal 8.1.

As with all approaches to regulation, this approach does not deliver “first best” outcomes. It may, however, represent a reasonable middle ground that is consistent with the objective of promoting efficient investment.

4.6.2 Alternative productivity based approach

This approach employs a CPI-X price cap to set average prices to be charged over the regulatory period. At the beginning of a review period, X is determined by reference to industry Total Factor Productivity (TFP). There is an initial (and once only) establishment of price based on cost (perhaps using a building block approach). Thereafter, price is adjusted by re-determinations of X reflecting estimated industry TFP at the beginning of each subsequent regulatory period.

The characteristics of this particular model include the following:

- it employs a price cap and a fixed regulatory period (generally not less than four or five years) to provide incentives to improve efficiency;

- it is light-handed and avoids the risk and intrusion that necessarily arise with models that require determination by regulation of ‘efficient’ costs;

- efficiency gains equal to estimated industry productivity are transferred to users;

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[44] On the other hand there are normal business pressures on the firm to minimise its costs to increase profits.

- this approach employs industry performance measures rather than those of any single firm as the basis for rate movements. There are some obvious similarities here with how the returns firms earn are determined in competitive markets, as service providers retain any efficiency gains above estimated industry-wide productivity levels;

- it removes the tendency for incentives to decline towards the end of a regulatory period;

- it leaves the service provider exposed to market risks – variations in general economic conditions, demand for services, and input costs and efficiency – but removes most regulatory risk;

- it also exposes the service provider (and to the extent to which this affects investment, the community) to the risk that factors related to its specific circumstances will prevent it from achieving industry productivity growth. Particularly when firm circumstances differ substantially, this may make the aggregate risk associated with this model considerable; and

- it does not true-up prices to cost after the initial price set.

While this approach has a number of attractive features including that it is light-handed, provides strong incentives, and mimics a competitive market, it would probably be criticised on the ground that it does not provide a mechanism for re-calibrating prices to costs.

4.7 Risky projects

As discussed in section 3.5.3 above, greenfields investments and other investments that are particularly risky raise very specific issues. As our proposed approach to these issues has already been set out in that section, we merely summarise some of its main features here:

- an approach similar to that used to calculate the Petroleum Resource Rent Tax. Price regulation would not apply until the NPV of the greenfields project, discounted by a factor equal to the relevant cost of capital, is positive. If the project becomes NPV positive then the benefits would be distributed 60 per cent to owners and 40 per cent to users. This approach would ensure that returns on successful projects would not be truncated at the cost of capital, thereby allowing some 'blue-sky' to offset the losses on projects that are not so successful. This would provide a more favourable environment for entrepreneurial investments; and/or

- an explicit regulatory contract between the regulator and the regulated firm. The terms of this contract would be agreed upon prior to the regulated firm making an investment in assets that the safe harbour process, noted above, indicates are likely to be subject to regulated access requirements under Part IIIA. Regulatory contracts could take one of two distinct forms:

    - a compact between the regulator and the regulated firm on the key regulatory parameters – that is, *ex ante* agreement on the parameters in the regulatory model that are determined by the regulator such as the beta weights to be used when calculating the weighted average cost of capital, whether or not assets will be vulnerable to regulatory stranding (that is, a cost optimisation modelling approach used), and if so the circumstances under which this would

occur (i.e. how the optimisation would be implemented), the period between regulatory resets etc. The regulator will be bound to agree to parameters that are proposed and that are consistent with the legislative pricing principles, subject to a strict material change in circumstances clause;[45] or

- an undertaking, which would detail the terms and conditions of access for the lifetime of the asset. Again, the regulator will be bound to agree to an undertaking that was consistent with the legislative pricing principles, subject to a strict material change in circumstances clause.

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45 We have proposed earlier that a number of these elements, for example *ex ante* determination of the cost of capital and risk components, be adopted in respect of all investments, not simply for risky investments.

5. Appeals and merits review

This section discusses some of the issues associated with processes for appeal and review arising out of the Position Paper, namely:

- the introduction of full merits reviews of all decisions on undertaking applications; and
- full appeal rights against decisions to declare services.

5.1 Full merits reviews on undertaking applications

5.1.1 The Commission's position

The Commission notes that, at present, the anomalous situation exists that merits review is not available of decisions by the ACCC regarding undertaking applications, although such review is possible in connection with declaration, certification and arbitration decisions.[46]

In discussing the introduction of such merits review rights for both facility owners (of a decision to reject an access undertaking) and access seekers (of proposed terms and conditions of access), the Commission:[47]

> acknowledges that the introduction of appeal rights for undertakings carries with it some risk of encouraging strategic behaviour by service providers. …
>
> However, the Commission is not convinced that, at least for the sort of 'residual' services likely to be declared under Part IIIA, this would be a material concern. It also notes that the introduction of indicative time limits for the various steps in the Part IIIA process … would limit the protection against declaration provided by the lodgement of strategic undertakings. Moreover, the assessment of a proposed undertaking, even if the proposal was clearly unacceptable, would facilitate speedy arbitration in the event that the service concerned was subsequently declared.

Accordingly, the Commission has proposed that:[48]

> Proposal 9.4 (Tier 1): Part IIIA should include provision for full merit review by the Australian Competition Tribunal of decisions on undertaking applications.

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[46] Position Paper, p.239.

[47] Position Paper, p.239.

[48] Position Paper, p.240.

5.1.2 Response

We strongly endorse the Commission's proposal for full merits review by the Australian Competition Tribunal of decisions by the ACCC relating to undertaking applications.

The policy rationale for administrative and judicial review is long-standing and well-accepted. It has been said of merits review that its principal objective is to:[49]

> ensure that those administrative decisions in relation to which review is provided are correct and preferable:
>
> - Correct - in the sense that they are made according to law; and
> - Preferable - in the sense that, if there is a range of decisions that are correct in law, the decision settled upon is the best that could have been made on the basis of relevant facts.
>
> This objective is directed to ensuring fair treatment of all persons affected by a decision.
>
> Merits review also has a broader, long-term objective of improving the quality and consistency of the decisions of primary decision-makers. Further, merits review ensures that the openness and accountability of decisions made by government are enhanced.

In our view, review rights impose a significant discipline on arbitrary and poorly founded decisions. In doing so, such rights reduce the very risk of such decisions occurring. Over time, then, the mere existence *per se* of such review rights may be seen to increase the level of regulatory certainty.

Indeed, in our view, the existence of full merits review is so fundamentally important it is difficult to conceive of any proper justification for failing to have such a process in place.

We note that the Administrative Review Council has provided a list of factors that may justify the exclusion of merits review and factors that do not justify such exclusion.[50] In our view, there is nothing in the Administrative Review Council's lists of factors which militate against the introduction of full merits review in the present context. The balance of this sub-section of this submission discusses two considerations in particular.

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[49] Refer to the Administrative Review Council's list of frequently-asked questions, which is found at: http://law.gov.au/aghome/other/arc/arcnew/faqs.html

[50] Administrative Review Council, *What decisions should be subject to judicial review?* 1999 (at Chapters 4-5) (available at: http://law.gov.au/aghome/other/arc/arcnew/faqs.html)

Extensive inquiry process already in place

As the ACCC has commented in its submission to the Commission,[51] one of the factors cited that may justify the exclusion of merits review is where the decision involves an extensive inquiry process. The Administrative Review Council specifically comments that:

> This exception covers decisions that are the product of processes that would be time-consuming and costly to repeat on review.
>
> 4.54. Such processes include public inquiries and consultations that require the participation of many people. If review of the subsequent decisions was undertaken, the nature of the review process would be changed from the normal adjudicative decision-making process (of, say, the AAT), to a greatly expanded and time-consuming one.
>
> 4.55. For example, the Council has advised that decisions made under the *Australian Heritage Commission Act 1975* to enter, or not to enter, a place on the Register of the National Estate would be inappropriate for external merits review, if the Act was amended to provide for those decisions to be made by a process involving public hearings.

In our view, the nature of the decisions at issue in the context of undertakings under Part IIIA is qualitatively different to the example cited by the Administrative Review Council because:

- the issues involved in access undertakings are significantly more complex and, therefore, there is significantly increased risk of arbitrary or poorly founded decisions occurring; and
- the issues are such that only a relatively small group of interested parties are able to contribute meaningfully to the debate. In such cases, the public hearings process may not draw to light, or indeed expose so readily to scrutiny, relevant and irrelevant considerations.

In our view, there is no logical reason why undertaking decisions should be treated differently as between, for example, Parts IIIA and XIC of the Trade Practices Act. Indeed, in view of the relationship between undertakings and declarations in Part IIIA as compared with Part XIC, we take the view that the argument for merits review is even stronger in the case of Part IIIA (given the risks of more heavy-handed and uncertain intervention being imposed on facility owners should an access undertaking be rejected by the ACCC).

Costs of merits review

Another consideration that the Administrative Review Council suggests would justify not allowing merits review in a particular case is where the relevant decision has such limited impact that the costs of review cannot be justified:[52]

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[51] Position Paper, p.239.

> 4.56. Merits review costs money. Given that the Government must allocate resources in an effective way, it would obviously be inappropriate to provide a system of merits review where the cost of that system would be vastly disproportionate to the significance of the decision under review.
>
> 4.57. For example, merits review of a decision not to waive a filing fee of, say, $150 may be difficult to justify on an economic basis. That said, the cost of review must be accounted for not only by comparison with the extent of the interests of any individual that may be affected, but also by comparison with the broader and beneficial effects that merits review is intended to have on the overall quality of government decision-making.

Of course, the costs of merits review may not simply be those costs directly associated with the process itself. It could also include what might be described as secondary costs, for example in the present case, costs associated with reductions in the timeliness of the undertaking process.

Certainly, there are some secondary costs associated with the Commission's proposal. However, we submit that these are more than outweighed by the important trade-off between speed and accuracy of regulatory decisions. Any 'costs' that may accrue from a six to twelve month merits review process are likely to be outweighed by the benefits of ensuring that the undertaking power is exercised in a manner consistent with that which Parliament (and economic analysis) would suggest is most applicable for regulatory intervention.

There would also be, obviously, some direct costs associated with the process. The Australian Competition Tribunal (and its predecessor, the Trade Practices Tribunal) has previously acted as a significant constraint on the discretion of the ACCC (and the former Trade Practices Commission) in the context of authorisations of Part IV conduct. Whilst the Australian Competition Tribunal (and its predecessor) has a strong history of independence, and has brought added rigour to the assessment of significant decisions under Part IV of the Act, in recent times it has struggled to manage an increasing workload. Our view is that such issues should be resolved, not by adopting the expedient of disregarding the important benefits to be had from merits review, but by providing the Australian Competition Tribunal with greater resources.

In summary, we consider that the significance of the decisions at issue and the importance of ensuring considered and properly analysed reasoning on the part of the ACCC outweigh any considerations relating to timeliness or additional costs. Accordingly, full merits review of undertaking application decisions by the ACCC should be adopted.

5.2 Full appeal rights against decisions to declare services

5.2.1 The Commission's position

In commenting on the general concerns expressed during the Part IIIA review regarding the time associated with appeals process, the Commission commented:[53]

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[52] Position Paper, p.239.

[53] Position Paper, pp.240-241.

> … it is hard to see how significant time could be saved without reducing current appeal rights. As a number of participants noted, there are inevitably trade-offs between timeliness and protection of property rights.
>
> …
>
> In the Commission's view, retaining adequate protection for the property rights of service providers should be the dominant constraint on any efforts to streamline Part IIIA appeal processes. In this regard, it considers that the least risky area for removing appeal rights would be for *accepted* declaration applications. The reason for this is two fold:
>
> - The implications of a declaration are unlikely to be fully evident until terms and conditions are established for particular access seekers. Hence, it is at the arbitration stage — where appeal rights would remain — that regulatory errors seemingly have the greatest potential to harm one or other of the parties.
>
> - The Commission's proposals for tightening the declaration criteria would reduce the scope for inappropriate declarations.
>
> …
>
> Removal of appeal rights for accepted declaration applications would mean that Part IIIA appeal rights accorded more closely with those in the Part XIC regime for telecommunications …
>
> The Commission also gave consideration to the suggestion from the ACCC that appeal rights for arbitration decisions which have been the subject of a public inquiry process be wound back.
>
> However, in its view, any such change would be premature. While there has been considerable experience with arbitration under the telecommunications access regime, there have been no arbitrations so far under Part IIIA. The Commission considers that any scope to streamline these appeal rights would be more appropriately addressed once there has been some practical experience with the current provisions.

Accordingly, the Commission has proposed that:

> Proposal 9.5 (Tier 2): Provision for appeals against decisions to declare services under Part IIIA should be abolished. (Provision for appeals against rejected declaration applications or arbitrated terms and conditions for declared services should, however, be retained.)

5.2.2 Response

In our strongly-held view, the Commission's proposal to abolish appeals against decisions to declare services should not be pursued under any circumstances. We consider that the high burden of proof resting on those who consider that appeal rights should be removed has not been met. We further consider that, if concerns regarding the timeliness of Part IIIA processes are valid, a far more appropriate way to address such concerns is through the introduction of decision timeframes within Part IIIA.

If we understand the Commission's position correctly, Proposal 9.5 is based upon the following principal considerations:

- concern has been expressed about timeliness of appeals;
- the 'least risky' area for removing appeal rights would be for accepted declaration applications because:
  - o regulatory errors seem to have the greatest potential to cause harm at the arbitration phase (where appeal rights remain); and
  - o scope for inappropriate declarations will be reduced under the Commission's proposals for tightening declaration criteria; and
- Part IIIA appeal rights would then accord with those existing under Part XIC of the Trade Practices Act.

Each of these aspects of the Commission's position is discussed below.

Concern about timeliness of appeals

We consider that the 'concerns' expressed regarding the timeliness of the appeals process are generally unwarranted:

- first, such concerns are, in our view, overly influenced by the *Sydney International Airport* decision.[54] However, the appeal in that case was stayed by the parties themselves and so cannot legitimately be cited as demonstrating any deficiencies in the appeals process *per se*. Indeed, more recent experience in the case of the *Duke* appeal[55] shows this to be the case; and
- secondly, the underlying rationale of a 'need for speed' is an intuitively appealing, but grossly over-simplified, argument.

There is no doubt that timeliness is an important consideration in providing resolution of issues regarding the obtaining of access under Part IIIA. Indeed, timeliness is an issue, and an ongoing concern, in judicial and administrative action generally.

Nonetheless, we are extremely concerned that the emphasis upon speed is at the expense of recognising the very high economic costs to society that arise from incorrect regulatory decisions.

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54 *Sydney International Airport* [2000] ACompT 1 (1 March 2000) (at: http://www.austlii.edu.au/cgi-bin/disp.pl/au/cases/cth/ACompT/2000/1.html?query=%7e+sydney+airport

55 *Duke Eastern Gas Pipeline Pty Ltd* [2001] ACompT 2 (4 May 2001) (at: http://www.austlii.edu.au/cgi-bin/disp.pl/au/cases/cth/ACompT/2001/2.html?query=%7e+sydney+airport

Such costs arise whether, for example, the decision is to declare or not to declare access to a particular service. These economic costs are well-known and do not need to be repeated here.

Even accepting the claimed concerns of timeliness and the consequent 'need for speed', it remains the case that there are other means available to overcome such concerns and which are significantly less drastic than removing appeal rights.

For example, the case could be made for the implementation of relevant time constraints within the Part IIIA processes. Such a change to the regime would ensure that concerns about timeliness are addressed, but also allow for scrutiny of regulatory decision-making to ensure that it is robust.

'Least risky' as a rationale

We are concerned that the Commission appears to see 'least risky' as a valid rationale for choosing a particular option over another.[56]

Such a characterisation could tend to convey an impression that a somewhat less than rigorous approach has been adopted to assessing the costs and benefits of imposing regulation (or, its counterpart, removing regulatory processes). It would be most unfortunate if:

- it were simply accepted, without any apparent analysis, that there was indeed a timeliness problem;
- no consideration was given to the range of alternative options to address such concerns (where such concerns are valid); and
- a decision was made to choose out of 2 possible options on the face of matters on the basis that one was 'less risky' than the other.

Although the Commission has said that 'retaining adequate protection for the property rights of service providers should be the dominant constraint on any efforts to streamline Part IIIA appeal processes',[57] it has apparently considered that such a dominant constraint on review generally may be satisfied by adopting a 'least risky' measure rather than pursuing any number of possible alternative approaches.

Lesser potential to cause harm

The Commission, as noted above, has suggested that Proposal 9.5 is the 'least risky' for two reasons, including that it has 'lesser potential to cause harm'.

Choosing the lesser of two evils does not appear, to us, to be a sound basis for policy decision-making.

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[56] Although it may be the case that this was simply a matter of unfortunate phrasing.

[57] Position Paper, p.240.

More importantly, however, we challenge the conclusion that either of the choices postulated has less potential to cause harm than the other. In the case of the election proposed by the Commission, we are of the view that the Commission has seriously underestimated the economic impact on, and potential harm to, facility owners of a declaration application being accepted. Such impact and potential harm cannot simply be ameliorated or redressed through the terms and conditions of access as the Commission arguably infers is the case. This is because, for example, such terms and conditions do not take into account the costs imposed on a firm of regulatory imposition or, indeed, the costs to society of such inappropriate regulation being in place.

If, in fact, retaining adequate protection for the property rights of service providers should be the dominant constraint on any efforts to streamline Part IIIA appeal processes, we are at a loss to understand why the interests of access seekers appear to have higher, and not simply equal, regard.

It is accepted that, if a declaration application is refused, then an access seeker would have no further avenues of redress to gain access without the right of appeal or merits review and it is therefore appropriate to retain such rights in those cases. However, the Commission argues that, in the converse case where a declaration application is accepted, somehow the potentially wrongful impacts of such a decision can somehow be cured through the terms and conditions of access. This approach ignores, however, the well-accepted costs of inappropriate regulation being in place at all. These costs cannot simply be avoided or compensated through access terms and conditions.

Reduction of likelihood of inappropriate declarations occurring

The second reason the Commission puts forward as to why Proposal 9.5 is the 'least risky' is that its other proposals for changes to the declaration criteria will reduce the likelihood of inappropriate declarations occurring.

Even accepting a degree of confidence that the Commission's other proposals will have this effect, it remains the case that:

- there will nonetheless be instances where inappropriate declarations will occur; and
- such instances of regulatory error should be redressed and not allowed to stand simply for the sake of expediency.

The range of potential interpretations open in relation to declaration criteria, as well as the potential for regulators to adopt inappropriate positions in the absence of review, makes, in our view, the risk of inappropriate declarations just as likely notwithstanding the Commission's proposal to strengthen the declaration criteria.

Alignment of Part IIIA appeal rights to Part XIC

Finally, we note that the Commission has cited, in support of Proposal 9.5, that Part IIIA appeal rights will be aligned to those in Part XIC of the Trade Practices Act.

Accepting the proposition that alignment is appropriate insofar as possible, the Commission's position assumes that the processes in Part XIC of the Trade Practices Act are: (a) appropriate *per se*; and (b) apposite to the cases falling generally within the purview of Part IIIA.

We would dispute the former proposition and, by necessary inference therefore, the latter. There are strong arguments as to why merits appeal on declaration decisions should be introduced into Part XIC of the Trade Practices Act, including that such rights provide one of the few effective constraints on regulatory creep.

6. Separate regulatory bodies

A subject of much discussion within the context of the Commission's review of Part IIIA has been the current separation between the regulatory functions of the NCC associated with declaration decisions on the one hand, and the regulatory functions of the ACCC, namely decisions in the context of arbitrations, on the other. Specifically, the question has arisen as to whether a single regulator should be allocated responsibility for both regulatory functions.

6.1 The Commission's position

The Commission, in discussing the various views put to it, comments that:[58]

> … where considerable discretion is involved in decisions about whether a regulation should apply in a particular case, the argument for … separation of responsibilities is strong. In essence, separation is likely to promote transparent and independent decision making on coverage issues. …
>
> As Part IIIA has evolved, the envisaged delineation of responsibilities between the ACCC and the NCC has become blurred. In particular, overlaps between the certification and undertaking processes have emerged.
>
> However, such overlaps need not be a cause for concern. That is, if the criteria relating to coverage and price setting are broadly common across the various Part IIIA access routes, then efficiency *may* not be significantly compromised. …
>
> But, at the same time, it is important to recognise that the degree of discretion involved in coverage decisions under Part IIIA is limited to a significant extent by the various criteria that must be met before a service can be declared or a regime certified as effective. This … weakens the in principle case for having dual regulators. …
>
> In addition, the current administrative structure is not without costs …
>
> Setting these considerations against the concern about increased concentration of decision making power under a single regulator model — particularly if Ministers no longer have an input to decisions — involves considerable judgment. On balance, the Commission considers that there is a case for making a single body responsible for administering Part IIIA.
>
> The Commission is not, however, attracted to the proposal to establish a new regulatory body. While a new regulator would be less beholden to precedents than the NCC or the ACCC, there would inevitably be added uncertainty as access providers and seekers sought to evaluate how it would behave. It would also take time for a new body to marshal the expertise necessary for effective policy making in this complex area. …

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58 Position Paper, p 229-231 (original emphasis).

> On balance, the Commission considers that, under a single regulator model, the regulator should probably be the ACCC. In reaching this conclusion, the Commission acknowledges that this would focus decision making power in a body widely perceived to give too much weight to short-term consumer interests. However, the Commission considers that this concern can be addressed by the implementation of criteria and pricing principles that give appropriate recognition to the needs of investors and dynamic efficiency.

Accordingly, the Commission has proposed that:[59]

> Proposal 9.2 (Tier 2): A single regulator should be assigned the responsibility for regulating all aspects of Part IIIA, subject to the relevant appeals processes. At this stage, the Commission is inclined to the view that this regulator should be the ACCC.

6.2 Response

We do not support the proposal for a single regulator. We consider that having different regulators at the different functional levels of access regulation imposes a significant discipline on the unwarranted extension of access regulation by the unilateral actions of the regulator.

6.2.1 Checks and balances

The current division of powers correctly recognises the need to distinguish between the policy decision (whether to regulate or not) and the regulatory process (on what terms and conditions should access be provided). The separation of functions currently operating under Part IIIA avoids the perceived conflict of interest that arises when the entity that will have powers to shape an activity, also has the power to determine whether it should or should not be placed in a position where it can do so. The fact that declarations under Part IIIA rest on an objective test, and are subject to full review by the Australian Competition Tribunal, further limits the risk of 'regulatory creep'.

An instructive illustration of the dangers of combining the policy and regulatory decisions in the one body may be found in the operation of Part XIC of the Trade Practices Act.

One of the direct consequences of handing the powers of declaration to the ACCC under that Part has been regulatory creep. The ACCC has the ability – if so-minded – to extend its own powers in terms of the determination process by declaring whatever eligible service it believes should come within the purview of Part XIC. The ACCC can effectively decide what it wants the market structure to look like and then implement this by controlling both declaration and determination.

The dangers of a single regulator have been recognised elsewhere. For example, in the United Kingdom, the Department of Trade & Industry has commented that:[60]

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[59] Position Paper, 232.

> 7.5 Conferring significant powers on individual regulators has produced a system where regulators have a strong element of individual responsibility. It may have had advantages in a period in which most regulators have been focused on driving forward competition.
>
> 7.6 But there are risks in concentrating too much discretion on an individual. There are few formal checks and balances on the regulators. In practice, the regulators have made ad hoc use of advisers to assist them, but there is no statutory obligation on them to do so, and no disciplines on the regulators to follow the advice given. They are not accountable to a board of directors or equivalent. There is a risk, therefore, of unpredictable and unaccountable decision making.

We submit that there are no reasons, as a matter of policy, why the current system of checks and balances contained in Part IIIA through the separation of the policy and regulatory functions should be overridden.

6.2.2 The degree of discretion

As noted above, the Commission has commented that, where considerable discretion is involved in decisions about whether a regulation should apply in a particular case, the argument for separation of responsibilities is strong. The Commission goes on to suggest that the degree of discretion involved in coverage decisions under Part IIIA is limited to a significant extent by the various criteria that must be met before a service can be declared or a regime certified as effective (particularly if the Commission's proposals for strengthening the relevant criteria are adopted), the in-principle case for having dual regulators is weakened.

The current (and proposed) criteria for declaration and certification tend, of themselves, to be capable of very broad interpretation. This is particularly the case with the criteria set out in paragraphs 44G(2)(c) and (f) of Part IIIA. As has similarly been commented in this submission in the context of the discussion about the inclusion of an objects clause in Part IIIA, the range of responses received in the course of the present inquiry alone show that there is scope for a very broad range of interpretation of different criteria. Furthermore, Part IIIA deals with a broad range of very different issues in the contexts of very different dynamics.

As such, we submit that there is a very large discretionary component (with broad general policy ramifications) within the application of the particular declaration criteria in particular cases, the exercise of which should remain with the NCC.

Similarly, in relation to the application of pricing principles in the context of arbitrations, there is also significant discretion available to the regulator as to how to apply the particular principles in a given case.

We submit that, were it not apparent that each of these areas – namely, declaration and arbitration – were fundamentally discretionary in nature, there would not be the evidence of the significant levels of regulatory debate and activity by the industries concerned.

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[60] Department of Trade & Industry, *A Fair Deal for Consumers: Modernising the Framework for Utility Regulation*, Green Paper, March 1998, Chapter 7, sections 7.5 and 7.6 (available at: http://www.dti.gov.uk/urt/fairdeal/part7.htm

Although it might be argued that there is no discretion in the sense of complete freedom of choice as to how to act and so the argument for separate regulators fails, we submit that discretion should not be so narrowly interpreted. If there is a choice as to how to proceed in applying a particular criterion, then relevant discretion exists.

6.2.3 The case of telecommunications and aviation

It is instructive to consider the distinction drawn by the Chairman of the ACCC for the adoption of different regulators in the context of declaration decisions as between Part IIIA and the telecommunications and airports access regimes. The Chairman has commented:[61]

> As telecommunications is a Commonwealth responsibility, the regime did not have to address Federal-State co-regulation issues. Consequently the ACCC (rather than the NCC) determines whether a service is declared. …
>
> Airports like telecommunications are also a Commonwealth responsibility and also required a different declaration process than that set out in Part IIIA.

In our view, ownership should not give rise to a different declaration process than that set out in Part IIIA, nor does it remove the justification for separate regulators.

6.2.4 The question of consistency

A number of participants in the present review have argued that the adoption of a single regulator would permit of greater consistency between the various decisions to be made.

As the experience of Part XIC of the Trade Practices Act readily shows, consistency of decision-making does not automatically follow a single regulator.

The argument for consistency, though, is misplaced in that it fails to give due emphasis to the entirely different nature of the decision-making concerned. Decisions about coverage of the regime – that is, policy decisions – are fundamentally different to decisions regarding the terms and conditions of access which take such policy decisions as a given and then seek to implement administrative arrangements that support such policy.

As such, we consider that the argument based upon consistency is simply expedient, rather than substantive.

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61 Professor Allan Fels, *The Benefits of Institutional Integration: Antitrust Enforcement and Regulatory Interventions in Australia*, October 2000 (at: http://www.accc.gov.au/speeches/2000/rome.htm

6.2.5 Costs of separate regulators

Notwithstanding, the Commission has apparently formed the view that the costs associated with maintaining separate regulators outweigh all of the considerations discussed above.

We recognise that there are costs associated with maintaining separate regulators. But considerations of cost *per se* should not cause this review to shrink from the accepted goal of having sound policy decision-making processes supported by appropriate checks and balances.

In any event, we consider that the considerations discussed in relation to cost are again fundamentally misconceived because:

- it is not a question of currently having two regulators performing the same function as each other and thus wasting costs through duplication – the roles of policy and administration are fundamentally different. Even if it were possible to combine them into one regulator, different people would generally be involved in the different functions achieving minimal, if any, costs savings and increasing the costs associated with other challenges of integration;[62] and

- the evidence of integration of declaration and arbitration decisions under Part XIC of the Trade Practices Act does not, in our view, lend any support to the claim that integration would reduce costs.

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62 In discussing the combination of regulatory and competition functions, the Chairman of the ACCC has noted that, where it has dual roles, the ACCC faces intense challenges to maintain direction: Professor Allan Fels, *The Benefits of Institutional Integration: Antitrust Enforcement and Regulatory Interventions in Australia*, October 2000, section 4 (at: http://www.accc.gov.au/speeches/2000/rome.htm)