The National Access Regime

Productivity Commission Review

Response to Position Paper

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The Submission

In February 2001 the New South Wales government provided a submission to the Productivity Commission on its Issues Paper on the National Access Regime.

In March 2001 the PC issued a Position Paper on the National Access Regime. The Position Paper seeks further comment from interested parties.

The PC's position paper includes a number of proposals to change the National Access Regime. Accordingly, it has grouped its proposals into two tiers:

- Tier 1 proposals are those which the Commission considers to be clearly beneficial.
- Tier 2 proposals are those which it considers have the potential to deliver further gains, but which involve more substantial changes to the regime's architecture.

The following tables summarise the PC's tier 1 and tier 2 proposals.

Table 1 – Summary of the PC's tier 1 proposals

5.1	Inclusion of an objects clause in Part IIIA relating to the promotion of efficient use of, and investment in, essential infrastructure facilities and recognising the regime's role in providing a framework for industry regimes.
5.2	Explicit recognition that Part IIIA applies to services provided by both vertically integrated and non-integrated entities.
5.3	Inclusion in Part IIIA of pricing principles to apply to arbitrations for declared services and assessments of proposed undertakings and the effectiveness of existing access regimes.
6.1	Modification of the declaration criteria to ensure that the provision of access must deliver a substantial increase in competition and to remove the possibility that services provided under conditions of duopoly or oligopoly could be declared.
6.3	A requirement for the provider of a declared service to give an access seeker sufficient information to permit meaningful negotiation.
6.5	Explicit mention in the Part IIIA arbitration criteria that determinations should promote the efficient use of, and investment in, essential infrastructure facilities.
6.6	A requirement for the ACCC to generally limit its involvement in arbitrations to matters in dispute between the parties.
6.7	A requirement for the ACCC to justify the introduction of non-efficiency considerations when arbitrating disputes for declared services, or assessing proposed undertakings.
6.8	Removal of the scope for the ACCC to require facility extensions when arbitrating a dispute for a declared service.
7.1	A requirement for the Commonwealth Government to submit its industry access regimes for certification.
7.2	Explicit provision that privatised services subject to statutory access regimes are to be assessed against the same effectiveness criteria as government-provided services.
7.5	Introduction of scope for service providers to lodge post-declaration undertakings.
7.6	Alignment of the criteria for assessing proposed undertakings with those applying to arbitrations for declared services and certification of existing access regimes.
8.1	Details of the pricing principles to be incorporated in Part IIIA.
9.1	Ending the role for Ministers in declaring and certifying services.
9.3	(If proposal 9.1 is not accepted) maintenance of the current 60 day time limit on ministerial decisions for declarations and extension of this limit to certifications.
9.4	Provision for full merit review of decisions on undertaking applications.
9.6	Legislative requirement for public comment on declaration and certification applications.

9.7	A requirement for the designated regulator(s) to publish reasons for its (their) decisions on declaration, certification and undertaking applications.
9.8	(If proposal 9.1 is not accepted) a requirement for Ministers to publish reasons for their decisions. Non-decisions by Ministers to be deemed as acceptance of the recommendation from the regulator.
9.9	A requirement for the ACCC to publish post-arbitration reports.
10.1	Exemption for certain regulated terms and conditions of access established under Part IIIA from Parts IV and VII of the Trade Practices Act.

Source: Productivity Commission (2001) Review of the National Access Regime – Position Paper p. 257

Table 2 – Summary of the PC's tier 2 proposals

6.2	Overhaul of the declaration criteria, focussing more directly on efficiency rather than simply promoting competition, and requiring that declaration would be likely to improve efficiency significantly.
6.4	Provision to commence arbitration 30 days after declaration of a service, unless both parties to the dispute notify the ACCC that a resolution is imminent.
7.3	Incorporation of the principles for assessing the effectiveness of existing access regimes within Part IIIA (rather than in Clause 6 of the CPA).
7.4	Modifications to streamline the current tests for effectiveness and to render them consistent with the modified Part IIIA architecture.
8.2	Consideration be given to making explicit provision for the use of productivity-based approaches for setting price caps in the tests for effectiveness of existing access regimes.
9.2	Making a single body responsible for administering Part IIIA — most probably the ACCC.
9.5	Amendment to Part IIIA appeal arrangements to remove provision for merit review of accepted declaration applications.

Source: Productivity Commission (2001) Review of the National Access Regime – Position Paper p. 258

Abbreviations

ACCC – Australian Competition and Consumer Commission
ARTC – Australian Rail Track Corporation
DAC – Depreciated Average Cost
DORC – Depreciated Optimised Replacement Cost
IPART – Independent Pricing and Regulatory Tribunal
NCC – National Competition Council
NCP – National Competition Policy
NECA – National Electricity Code Administrator
NEC – National Electricity Code
PC – Productivity Commission

1. Background

In 1995, the State, Territory and Commonwealth Governments signed the Competition Principles Agreement which formalised the implementation of National Competition Policy (NCP). NCP seeks to promote greater competition within the economy as a means of improving economic performance. The National Access Regime is one component of NCP that seeks to facilitate access to infrastructure with a view to promoting greater competition in upstream and downstream markets.

The National Access Regime, as it has evolved, is relevant to Gas, Rail, Ports and Electricity industries, whereas Telecommunications, Australia Post and Airports are either partially or completely outside the provisions of the National Access Regime.

From the NSW Government's perspective the National Access Regime is of particular relevance to Rail, Electricity and Gas operations.

Rail

The NSW Rail Access Regime was certified for a 12-month period until 31 December 2000. This certification has expired and NSW is not currently seeking to renew its certification.

Electricity

The National Electricity Code (NEC) governs the national electricity market. The Code relates to transmission, distribution and retailing operations. It details arrangements for access to transmission and distribution networks. Various facets of the NEC are administered by the ACCC, the NEC administrator and State regulators, ie IPART for NSW.

Gas

The National Gas Access Code was approved in 1997. The Code details arrangements for access to natural gas pipelines for both service providers and users. NSW sought certification of its gas access regime in October 1998, following certification of an earlier regime in August 1997. The certification of the NSW gas access regime has been delayed pending resolution of cross-vesting issues.

Submission Structure

Section 2 of this report addresses some general issues raised in the PC's report. Sections 3 and 4 detail the New South Wales response to the PC's Tier 1 and 2 proposals.

This submission does not seek to address every component of the PC's Position Paper, rather it focuses on areas of particular importance.

2. Introduction

NSW supports the arguments presented by the Law Council (PC Position Paper - page 4) that third party access legislation represents an intrusive form of regulation. While third party access has the potential to improve competitiveness in upstream or downstream markets it can reduce the incentive to innovate and invest, if arbitrated terms and conditions disadvantage the facility owner.

2.1. Generic or Industry Specific Access Regulation

NSW notes that industry specific regimes are likely to continue to operate in tandem with a national access regime under Pt IIIA (PC Position Paper – pages 90-94). NSW considers that the key elements of the Pt IIIA arrangements, including proposed appeals processes, should be part of all industry specific regimes. For example, NSW notes that there is no scope for appeals under the Payment System Act. Such critical differences may encourage undesirable strategic behaviour, to avoid the application of core regulatory principles.

For the transport sector overall NSW notes that rail is more heavily regulated than road. Rail transport is subject to strongly enforced speed, load and hours of operation restrictions. While road transport has similar restrictions they are much easier to avoid. It is important that regulators take into consideration the competitive neutrality of industry regulation with the objective being a “level playing field” outcome.

2.2. Monopoly Power

NSW endorses the PC’s view (PC Position Paper page 110) that the focus of access regimes should remain on natural monopolies. The distinction draws on the technical characteristics of the facilities or services, and a general proposition that regulatory solutions should not over-ride market dynamics. Natural monopolies suggest a more permanent structural barrier to competition. Network externalities are potentially more transient and may be more easily overcome by technological innovation.

2.3. Asset Valuation

The first best alternative to asset valuation is through a competitive market. However, for large scale infrastructure, ie Gas, Electricity and Rail, there is often no competitive market for the purchasing of assets. In the absence of a competitive market a second best asset valuation technique needs to be employed, eg Depreciated Optimised Replacement Cost (DORC) or Depreciated Average Cost (DAC) or Historical Cost.

As a general comment, NSW supports the use of Depreciated Optimised Replacement Cost (DORC) as a conceptually valid approach for asset valuation purposes. The main advantage of DORC as a technique for valuing starting asset values relates to the fact it synthesises the outcomes that would be achieved in a competitive market.

However the theoretical strengths of DORC are also, quite paradoxically, its weaknesses as an asset valuation framework. In order to determine efficient asset values, costs are often assigned in an arbitrary manner. The subjectiveness of cost allocations suggests that the strict application of DORC may produce a range of valuation outcomes and may not be overly helpful in determining a realistic representation of the economic value of infrastructure assets.

In addition to this, the threat of optimising out capital investment expenditures (assigning a zero value to investment) incurred throughout the regulatory period creates significant regulatory risk and may result in perverse disincentives to infrastructure operators for new capital investment. For instance, an operator may not undertake certain works due to the threat of a regulator deciding that the works are not essential (optimising them out). Therefore regulation can potentially impose efficiency costs if it unduly impinges upon commercial investment decisions.

Finally, it is important to recognise that rate of return assessments and asset valuation techniques are critically related in access regimes. However, the tendency is for rate of return and asset valuation assessment to be undertaken separately by regulators. This results in infrastructure operators trading off the result of asset valuations against rate of return assessments.

3. Tier 1 Proposals

As previously identified, the Tier 1 proposals are those that the PC judges to be of clear benefit to the community. This section only responds to specific tier 1 proposals.

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

The guiding principle and objective of any access regime should be to enhance overall economic efficiency by promoting efficient use of, and investment in, essential infrastructure services.

The PC correctly recognises that infrastructure owners and access seekers have different perceptions of whether the national access regime should relate to long-term or short-term economic efficiency. However, the PC's report does not address what the balance should be between short-run and long-run economic efficiency. This position weakens proposal 5.1 as it does not contribute to resolving this debate.

Discarding these different perspectives it is important that the national access regime does not undermine the long-run viability of infrastructure facilities. It is necessary for access pricing arrangements to provide the right economic incentives for efficient investment in new and existing 'essential' infrastructure without compromising 'fair' access to, or use of, facilities.

The granting of access based on short-run economic efficiency grounds (short run marginal cost) potentially discourages innovation and investment in the future, whereas long-run economic efficiency (long-run marginal cost) will maximise both consumer and producer surplus, over time.

In proposal 8.1 the PC recognises that revenue generated must be at least sufficient to meet the efficient long-run costs of providing access. Similarly, the objectives should highlight the importance of long-run efficiency.

5.2 There should be explicit recognition in Part IIIA that the regime covers eligible services provided by both vertically integrated and non-integrated facilities.

Although NSW is generally supportive of the proposition that natural monopoly facilities may lead to efficiency losses, regardless of industry structure, the economic circumstances can vary substantially, depending on whether the facility is vertically integrated or not. For example, whereas the owner of a vertically integrated facility may have a strong commercial incentive to deny entry to rivals in downstream markets, the same exclusionary incentive does not necessarily apply to operators of non-integrated

facilities. Interestingly, it was suggested in submissions to the PC that operators of non-integrated facilities may restrict output and extract monopoly rents.

NSW supports the notion that a non-integrated facility owner will seek to maximise asset utilisation and hence financial return. Therefore, it would be appropriate to allow differential pricing for facilities that are not vertically integrated, with prices oversight to monitor for monopolistic rent taking.

Therefore, Part IIIA should cover vertically integrated and non-integrated facilities, on the proviso that different regulatory approaches apply to vertically integrated and non-integrated facilities.

5.3 Pricing principles should be included in Part IIIA with application to arbitrations for declared services, assessments of undertakings and evaluations of whether existing access regimes are effective.

NSW supports this proposal in principle, and that these principles should apply to all forms of access undertaking.

Similar to the statement of objectives which relate to efficient use of infrastructure it is essential that any pricing principles are tailored to long-run economic efficiency. Static short-run concepts of economic efficiency are incompatible with the notion of financial viability because short run marginal cost pricing may not generate sufficient revenues to recover the fixed or sunk costs of infrastructure assets.

As was stated in response to recommendation 5.1, it is important that the national access regime does not hamper the long-run viability of infrastructure operators. Long-run economic efficiency maximises consumer and producer surplus over time, whereas short run-economic efficiency may stifle innovation and future investment.

It is not be possible to provide detailed pricing principles that apply to all situations. Nonetheless, broad principles based on recovering long-run variable costs should remove impediments to innovation and future investment by access providers.

For existing infrastructure (sunk assets) NSW supports the floor/ ceiling price approach to setting efficient prices whereby access prices are set between a minimum floor price and a threshold ceiling price (representing fully distributed or stand-alone costs). Such non-prescriptive pricing arrangements promote economic efficiency because access seekers must negotiate directly with access providers. Under these conditions, market based outcomes will almost always facilitate a better allocation of resources than prescriptive regulation or static price setting arrangements, as access seekers willingness to pay will improve economic efficiency.

The key issue with regards to floor and ceiling prices is the level at which floor prices are set. If the objective is short-run economic efficiency then the floor price should be set at SRMC, however, SRMC pricing does not recover the sunk costs associated with

infrastructure assets. Therefore, NSW supports floor prices that are set on long-run economic efficiency grounds at long run marginal cost (LRMC). The ceiling price would include a return on investment commensurate with risks.

For new infrastructure it is important that regulated revenue caps do not discourage investment. Providers of new infrastructure are exposed to a number of risks. Firstly, where there are a small number of customers the withdrawal of one user may significantly affect profitability. Secondly, the infrastructure provider has to obtain finance for the proposed infrastructure. A financier will expect to be repaid within 15 years, whereas an asset may have a working life of up to 50 years. A regulator's asset valuation and rate of return caps must not undermine loan financing.

8.1 The Pricing principles in Part IIIA should specify that access prices should:

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

Access prices are efficient if the price charged for access equates to the value that is placed on right to access by the market. Efficient access prices also signal to access seekers the full efficient costs of access provision (including the forward-looking costs of new capital investment). However in terms of setting efficient access prices, the notion of economic efficiency will vary substantially between access seekers (who will prefer access prices based on efficient short run costs) and access providers (who will have a preference for prices to reflect long run incremental costs).

NSW supports the PC's view that revenue should reflect the efficient long-run cost of providing access to these services. As noted above, prices based on short-run marginal cost (SRMC) do not recover the fixed, sunk costs that are typically associated with essential infrastructure provision. Almost all infrastructure businesses set prices on forward-looking, long run marginal costs (LRMC) because financial viability is a fundamental objective of any owner/investor.

This approach to pricing will help to ensure the long-run viability of infrastructure in NSW and Australia. Unless revenue reflects long-run efficient costs (long run marginal costs) access providers will have no incentive to invest for the future.

NSW endorses the PC's conclusion that price discrimination can aid efficiency, and supports the PC in questioning whether non-discrimination should be included as a

principle in regimes such as the National Electricity Code. NSW notes that this clause has created some problems in the minds of access seekers and access providers alike in attempts to offer specific tariffs to encourage new (large) users, and to avoid inefficient by-pass of the existing network.

In regard to the earlier discussion regarding coverage of access regimes for non-integrated facilities, the ability to price discriminate to maximise utilisation of infrastructure facilities is one of the potentially substantial differences between integrated and non-integrated facilities, and significantly qualifies the relevance of access regulation for non-integrated facilities. For instance, NSW has already recommended that differential pricing be allowed for facilities that are not vertically integrated. Positive price discrimination enables access providers to achieve the twin objectives of enhancing overall economic efficiency whilst encouraging a sustainable level of investment in infrastructure. This will be achieved through prices being set according to access seekers' willingness to pay.

NSW cautions, however, that price discrimination is efficient as long as the monopolist cannot engage in monopolistic pricing practices. In other words, the use of Ramsey pricing principles to generate sufficient revenue streams to recover fixed and future capital costs will be effective so long as access providers are subjected to an overall revenue constraint. This revenue constraint should include some incentive mechanism for the access provider to increase efficiency, eg CPI-X. This mechanism should seek to encourage market-oriented outcomes, with the access seeker being free to negotiate terms and conditions with the access provider without the need for overbearing regulatory control or pricing oversight.

In this regard, NSW supports the use of differential access prices as long as:
- the access provider can set price levels based on value to consumers, ie willingness to pay (and possibly subject to side constraints if they are required for social policy purposes);
- the monopolist is prevented from exploiting their monopoly position (through the imposition of revenue or price caps);
- access seekers can be ring-fenced and separated for charging purposes; and
- price discrimination does not reduce competition in another market.

In all of this, however, regulation should be administered in situations where there is a clear and unambiguous public benefit from constraining the activities of the monopolist.

Finally, NSW envisages that in the long-term as competition grows in regulated markets, the need for regulation should decrease and competitive pressures should replace regulatory intervention.

9.1 The decision making role of Ministers in Part IIIA should be ended. Decision making should instead be the sole responsibility of the designated regulatory body(ies), according to criteria spelt out in the legislation, and subject to the specified appeal provisions.

Access regulation is still in the process of being properly established, and the policy consequences of regulation are still being assessed. In this environment NSW considers that there remains a strong argument for retaining the role of Ministers, who through their decisions, provide guidance on the scope of application of access regimes. The proposal also raises issues of who is better placed to make what are essentially policy decisions about major state infrastructure, the Government or a regulator.

The alternative model, of allowing the ACCC/NCC to determine the scope of regulation, has the regulator set the ‘materiality’ test for intervention. It is not clear that the proposed efficiency criterion will be sufficient to alleviate the concern that the regulatory scope can grow beyond desirable bounds. In the extreme, the risk is that the regulator (eg ACCC) may seek to extend the reach of Pt IIIA to address perceived limitations of Pt IV provisions of the *Trade Practices Act*. Such discretion could lead to the regulator unilaterally adjusting the operation of competition regulation in Australia.

NSW does not support the proposal that Ministers be required to give reasons for their decisions, as the right of applicants to seek review of the Minister's decision by the Australian Competition Tribunal gives adequate protection for applicants.

9.3 Timeliness of decision making

The Commission seeks participants' views on the NCC's suggested target time limits for declaration and certification processes, and whether such time limits should apply to assessment of undertakings and arbitrations for declared services

The NCC proposal would represent an improvement on the current arrangements. In the case of limits on the Australia Competition Tribunal in reviewing Ministers' decisions, an extension of time would need to be available if the proceedings were delayed by an appeal on a question of law to the Federal Court. However, unless the NCC is able to identify at an early stage all matters that need to be attended to for a certification application to be acceptable, then there is a risk that the proposed time limits could encourage the NCC to recommend against certification more often.

As put forward in the previous submission by NSW, the timeliness of decision making could be enhanced by a more clearly defined and limited process for public consultation. NSW would support the Commission's proposal that Part IIIA should make legislative provision for public comment on applications for declaration and certification, and proposed access undertakings.

4. Tier 2 Proposals

As previously identified, the Tier 2 proposals are those that the PC judges would offer further gains, but which might also have significant implementation costs.

9.2 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.

NSW supports the PC's recommendation that the ACCC should be the sole regulator with responsibility for regulating all aspects of Part IIIA. NSW is of the view that the NCC's role should be restricted to compliance assessment. However, this recommendation should only proceed in the light of other recommendations to clarify the scope of the access regime and to improve the accountability of the regulator.

NSW recommends that IPART, in the case of NSW, and the relevant regulators of other states should have a continuing role in relation to State access regimes.