



THE CABINET OFFICE
NEW SOUTH WALES

Mr Gary Banks
Chairman
Productivity Commission
PO Box 80
Belconnen ACT 2616

2 FEB 2001

Attention: Alan Johnston

Dear Mr Banks

National Access Regime inquiry

Attached is the New South Wales Government's submission on the Issues Paper for this review.

The submission raises a number of issues of concern to NSW. The primary issues are:

1. Deficiencies in the process for certifying industry specific regimes.

NSW encountered a number of deficiencies in this process when it applied to have its rail access regime certified. The process was found to be unnecessarily long, taking two and a half years to complete. In the end, certification was only granted for a thirteen-month period, which was an unsatisfactory outcome given the amount of time and resources that went into the application. The attached submission recommends a range of reforms aimed at streamlining and improving this process.

2. The existence of concurrent access routes.

NSW is concerned that concurrent regimes can exist to provide access to the same facility. Confusion and market uncertainty can result where a facility is subject to both a certified industry specific regime and an undertaking authorised under Part III A, as was the case with the Duke Energy operated Eastern Gas Pipeline. NSW believes that consideration should be given to amending Part III A for the purpose of rectifying this situation.

3. Retention of the dual system of access regulation.

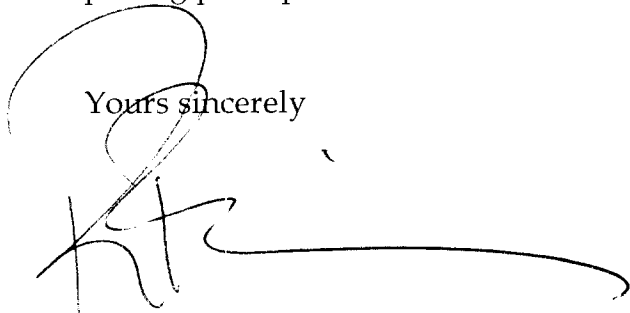
The current system, which involves a generic national regime alongside a network of national and state based industry specific regimes, provides a good balance between regulatory flexibility and national consistency. NSW is of the view that there is no case for making any significant changes to the current system.

4. Retention of a "national significance" test for determining what facilities should be subject to declaration.

NSW would not support replacing this test with a more general materiality test. Such a move could result in the capture of certain intrastate facilities that were never intended to come under the scope of the national access regime. However, the current national significance test is somewhat subjective and is in need of clarification.

The attached submission also provides extensive comment on a range of other matters, such as: clarifying the objectives of Part III A; the inclusion of explicit pricing principles; and the nature and scope of access regulation.

Yours sincerely

A handwritten signature in black ink, appearing to be 'RW', with a long horizontal flourish extending to the right.

Roger B Wilkins
Director-General

REVIEW OF THE NATIONAL ACCESS REGIME – ISSUES PAPER

A SUBMISSION FROM THE NEW SOUTH WALES GOVERNMENT

Abbreviations used in this Submission

ACCC – Australian Competition and Consumer Commission

NCC – National Competition Council

IPART – Independent Pricing and Regulatory Tribunal of NSW

NECA – National Electricity Code Administrator

RAR – The NSW Rail Access Regime

COMMENTS ON SPECIFIC ISSUES RAISED IN THE PAPER

Chapter 4 – Rationale for a National Access Regime.

Nature of underlying problem.

Should vertically integrated bottleneck facilities be treated differently than non-integrated facilities? Is the real concern underpinning access regime denial of access, or the price and conditions of access? Are the two concepts separable from a regulatory point of view, or should they be addressed in tandem? (p. 17)

Denial of access, and the price and condition of access are significant issues. Conceptually, these issues are not separable from a regulatory viewpoint. If access were to be offered on extremely unfavorable terms and conditions, it is likely that no rational agent would seek access and hence the same outcome follows. From a property rights point of view, an owner of a facility should have the same entitlement to refuse access entirely as to set prices and conditions for access. Conversely, if a facility owner does not have the right to deny access, the owner should not have the right to freely set prices for access (noting that Part IIIA requires negotiation in these cases).

Does denial of access (or monopoly pricing of access) have significant efficiency effects, or does it result mainly in transfers of income? Are there circumstances where one or other effect would predominate? From a policy perspective, is this distinction important? (p. 17)

The answer to this question depends on whether the relevant facility is vertically separated from upstream or downstream markets.

If the facility owner has significant interests in, say, downstream markets, there may be an incentive to provide access on terms that discourage competition in those downstream markets. It is likely this would lead to losses in economic efficiency, as prices are higher and consumption lower in the downstream markets than would be socially optimal.

However, where the facility is properly ring-fenced from upstream or downstream markets (through separate ownership or corporate structures), facility owners will have the incentive to maximise returns from the facility. The rational outcome would be a two-part pricing regime, whereby variable costs were recovered through an incremental charge whilst fixed costs were recovered through a fixed charge that did not vary with consumption. The facility owner would have an incentive to set the fixed charge at a level that captured the greatest possible proportion of the consumer surplus associated with use of the facility, whilst not deterring use of the facility. This means that denial of access should not occur unless the access seeker was not willing to at least pay the incremental costs of usage.

In the case of most infrastructure facilities that are vertically separated, two-part pricing of access will generally result in transfers of income, at least in the short term, rather than efficiency losses. Higher fixed prices chiefly result in increases in producer surpluses at the expense of consumer surpluses, rather than a net reduction in total economic benefits.

The policy distinction is important if and when an assessment of the case for regulation of access to facilities is made. Regulation of access can only be justified on the basis of expected net increases in overall benefits whether in the short or long run, not merely on the basis of transfers. This implies that in the majority of cases where there is vertical separation of the facility from upstream and downstream sectors, there will be little justification for regulation of access. The application of Part IIIA may be inappropriate in such cases and is likely to impose unnecessary costs of regulation on industry and society.

The role for formal access regulation.

What is the evidence that access regulation reduces prices and/or improves the range and quality of services available to end-users? (p. 18)

Below are some examples from a NSW perspective of where access regulation has contributed to a reduction in prices.

RAIL

Rail haulage of coal has typically been over-priced while, historically, general rail freight services in Australia have been under-priced. Resistance has come from private operators in general freight when asked to pay on a more commercial basis. Resistance, in part, may be affected by the availability of competing road services that arguably may not be covering their full costs. Some interstate operators have claimed that prices negotiated in other states should apply in NSW.

The introduction of the access regime in NSW has resulted in a real 30% reduction in rates charged for hauling coal in the Hunter Valley over the last seven years. The Government agreed to phase out any monopoly rents by 2000.

GAS

The introduction of a gas access regime provided a framework for new entrants. The prices received by AGL have fallen since the introduction of the gas access regime eliminating AGL's monopoly rents. IPART recently identified in the Access Arrangement for AGL that contract revenue would fall from \$146 million in 1996/97 to \$45 million in 2003/04. NSW is of the view that price regulation would not have achieved the same outcomes.

ELECTRICITY

NSW Treasury estimates that between May 1995, when the NSW Government commenced its electricity reforms, and June 2000, NSW electricity customers saved over \$1,500 million in real terms on their power bills. The facilitation of competition in retail markets provided the bulk of these savings, but regulation of and access to monopoly networks was an integral part of these reforms.

Industry specific arrangements vs. a national regime.

Should access regulation be in the form of a national regime, industry specific arrangements, or a combination of both? If a dual system is to be retained, is the current relationship between the national regime and industry specific arrangements broadly appropriate? (p. 20)

NSW views the current dual system as providing an appropriate balance between national consistency and regulatory flexibility. Also, as noted in the Issues Paper, any move towards a total reliance on either a national regime or industry specific arrangements would involve considerable transitional costs. This should rule out any significant change to the current system at this stage.

Chapter 5 – Improving the Current National Access Regime.

Objectives and coverage.

Should the national access regime contain a clearer statement of objectives? What should these objectives be? Is promoting competition in related markets an objective in its own right? Or is it a means to fulfil broader objectives? (p. 21)

NSW concurs with the Productivity Commission in its observation that Part IIIA should have a statement of objectives. The promotion of competition in another market as a *de facto* objective is not a sufficiently rigorous motivation for a national access regime. The key objective of Part IIIA should be to promote long run economic efficiency – that is, maximise the sum of consumer and producer surplus over a period of time. In addition, the promotion of “efficient facility use” and “efficient investment” could be inserted as subsidiary objectives. This set of objectives recognises the interests of policy makers in “promoting competition” and the interests of facility owners in “ensuring a reasonable return on their assets that facilitates appropriate levels of maintenance and investment”.

If Part IIIA were to have application beyond natural monopolies, what other market situations should it target? Would it be possible/desirable to be prescriptive in this regard, or should the legislation simply leave open the option for wider application? Where monopoly power arises from a legislative restriction on competition, would it be better to address that restriction directly, rather than attempting to offset its impacts through mandated access? (p. 23)

NSW recommends that rather than imposing more regulations to achieve competitive outcomes, the legislation should be reviewed to remove competitive restrictions. The imposition of more regulations has the potential to create new restrictions, whereas review of the legislation to remove the restriction potentially could avoid this occurring.

Would it be sensible to define a list of industries to which the regime applies, or does changing technology make this an inappropriate approach? Were a listing approach adopted, what sort of facilities should be included? (p. 23)

The economy is constantly evolving and with it industries are changing. NSW is of the opinion that it would not be possible to produce an exhaustive list of industries to which the regime would apply. Technological change would tend to undermine the currency of any list that is produced.

Is the list of activities currently excluded from Part IIIA appropriate? Does the exclusion of 'production processes' create particular problems? For example, could it encourage firms to integrate vertically to avoid declaration under the regime? (p. 23)

It is too early to tell whether industry would seek to vertically integrate to avoid declaration under a regime.

At this stage no problems have been identified with the exclusions from Part IIIA. However, that does not mean that problems will not occur. Industry should be monitored to assess whether the exclusions encourage vertical integration to avoid declaration under the regime.

What is meant by national significance? What sorts of facilities clearly meet, or fall outside, this test? In seeking to delineate the national and State-based access regimes, could the national significance criterion leave important intrastate facilities outside the purview of any regime? (p. 26)

There is an element of subjectivity in deciding on whether a facility is of national significance. Clarification on what constitutes national significance would provide more guidance for access seekers, providers and regulators.

Is a national significance test for declaration necessary? Could materiality concerns be adequately addressed by a requirement that denial of access to facility would have large and adverse economic effects? (p. 27)

NSW would not support replacing the national significance test with a general materiality test, as this could result in Part IIIA capturing certain intrastate facilities that were never intended to come under the scope of a national access regime.

Certifications and undertakings.

How well are the certification and undertaking mechanisms working? What improvements could be made to them? (p. 28)

The certification of the NSW Rail Access Regime (RAR) has exposed serious deficiencies in the certification process. The primary issues of concern were:

- It took 2½ years to negotiate.
- During this time, access to the NSW rail network was vulnerable to a declaration. In fact, the NCC accepted an application by the NSW Minerals Council for declaration of the Hunter Valley rail track. The declaration became the subject of proceedings in the Australian Competition Tribunal, as the designated Minister (the NSW Premier) did not accept the declaration.
- During the certification process the RAR, or parts of it, was subject to public exhibition on six separate occasions, three of which were at the invitation of the NCC.
- Eventually, the RAR was granted certification for a period of 13 months. This period expired on 31 December 2000.

NSW found the process to be totally unsatisfactory. Considerable effort went to obtaining an outcome that resulted in marginal benefit. Therefore, the following reforms are recommended:

- After receiving an application for certification, there should be an obligation on the NCC to inform the applicant of all the objections it has to the proposed regime in one go. The NCC should not be allowed to continually raise new objections throughout the process.
- There should be a specified time frame for the NCC decision-making process. It should present its objections within a specified period after receiving an initial application, and once an amended application has been received, the NCC should deliver its recommendation to either reject or accept the application within a specified period.
- The NCC should be limited to initiating one public exhibition during the certification process.
- Twelve months is too short a period for certification, given the amount of effort that goes into an application. A five-year period would be more appropriate.
- Part IIIA should be amended to allow for a “simple” process for extending certification once it has expired. This extension should apply where there has been no material changes to the regime, or underlying market conditions.

What would be the pros and cons of combining the current certification and undertaking arrangements in a single ‘certification’ regime? Does the current dual arrangement have a strongly grounded public policy rationale? Does it increase the potential for inconsistencies in regulatory approach? (p. 28)

The existence of dual access routes, particularly those applying to natural gas pipelines, creates market uncertainty and provides opportunity for parties to choose the regulatory regime in which they operate under. From a public policy viewpoint, it is inappropriate to have different regulatory routes to achieve similar goals. In addition, the different criteria for assessing certification and undertaking also create confusion and market uncertainty.

NSW believes that, unless there is a clear public benefit in retaining the dual access routes, consideration should be given to amending Part IIIA so that access is either provided through a certified regime or an undertaking. As a general rule, NSW has a preference for access to be provided via a certified industry specific regime, such as the National Access Code for Natural Gas Pipelines, as these regimes provide greater scope for consistency and market certainty.

Is there a rationale for having different criteria for the three access routes accommodated by Part IIIA? (p. 29)

As previously noted, different assessment criteria, combined with the existence of dual access routes, can result in market uncertainty.

Does the specification of tests for an effective State/Territory regime provide sufficient scope for significant variation in industry specific access requirements, either for like facilities across jurisdictions, or between different classes of infrastructure? Does this enhance or reduce efficiency? Does it increase compliance costs for firms operating in more than one jurisdiction? (p. 29)

The existing system of State/Territory industry specific access regimes provides regulatory flexibility. The system allows for regimes to be tailored to local conditions, while simultaneously operating in an overarching national framework, thereby, enhancing efficiency and achieving better outcomes. NSW would be concerned with any changes that would diminish this flexibility.

Role of Ministers.

Is there sufficient onus on Ministers to justify departures from NCC recommendations? Would it be desirable to provide for a greater onus in the legislation? (p. 30)

NSW does not consider it necessary to introduce a legislative requirement for designated Ministers to justify their decisions. This is because affected parties have the right to appeal a ministerial decision to the Australian Competition Tribunal.

Administrative efficiency.

How well does Part IIIA perform in terms of administrative efficiency? Where are the main bottlenecks in Part IIIA processes? How might these be addressed? (p. 31)

As previously noted, the NSW experience in obtaining certification for its RAR identified considerable inefficiencies in Part IIIA processes. See previous comments re certification processes for details and suggested remedies.

Why is there a need for both the NCC and the ACCC to be involved in the administration of Part IIIA? If a single body were to administer the regime, which of the current two bodies would be preferable? (p. 32)

NSW is of the view that the NCC's role should be restricted to compliance assessment against NCP principles, and the subsequent provision of advice to the Commonwealth Treasurer. This would leave the ACCC as the sole regulator responsible for the administration of Part IIIA. There should be a continuing role for IPART in relation to State access arrangements.

Does the ACCC's role in policing other parts of the TPA that potentially impinge on access arrangements create any problems? Or does it help to promote a more uniform approach to related regulatory issues? Should these be considerations in determining which body should administer Part IIIA, were a single regulator model adopted? (p. 32)

NSW does not view the ACCC's role in policing other parts of the TPA as impinging on access arrangements. This other role assists in the efficient administration of the Act and facilitates informed and consistent decision making with regard to access arrangements.

Chapter 6 – Pricing Issues

Should Part IIIA include some explicit pricing principles/rules? Is there a need to tailor pricing regimes to the circumstances of particular industries? Does this militate against going beyond the inclusion of broad pricing principles in the legislation? (p. 33)

Any explicit pricing principles should be consistent with the proposed objectives for Part IIIA referred to previously in this submission. That is, maximisation of long-run economic efficiency should be the principal objective, with efficient facility use and efficient investment as subsidiary objectives. Any set of pricing principles should strive to strike a balance between pricing at incremental cost and providing a reasonable return on fixed assets.

What should be the balance between pricing existing capacity efficiently, and encouraging investment in maintaining and developing existing facilities or in new facilities? Are the two goals necessarily at odds? For example, can two-part pricing regimes accommodate both short and longer-run requirements? How can access pricing regimes best deter the entry of firms that are unable to deliver services in related markets as efficiently as the facility owner? (p. 33)

There should not be a major conflict between these goals. It should be possible to structure two-part pricing regimes so that unit prices reflect incremental costs and to set fixed connection prices so as to not deter new entrants. In any event, attempts should be made to minimise the extent of conflict.

What constitutes anti-competitive discriminatory pricing? For example, should pricing principles allow for some price discrimination between access seekers based on the nature and level of their demand? If so, how should regulators differentiate between efficiency-enhancing discrimination and anti-competitive behaviour? Does Clause 6.4 (f) of the CPA — stating that terms and conditions need not be exactly the same for all access seekers — provide sufficient scope for efficiency-enhancing price discrimination? (p. 34)

Access pricing principles should permit price discrimination between access seekers based on their respective willingness-to-pay, so long as the facility is ring-fenced from upstream and downstream markets. This is economically efficient. There should be no conflict between allowing efficient pricing and preventing anti-competitive pricing. In a typical two-part pricing regime, the variable charge should reflect the incremental cost of providing the service, whereas the flagfall charge should recover fixed costs. It is the flagfall that should be capable of being varied, depending on customers' elasticity or inelasticity of demand for the service.

If the facility is ring-fenced, it is difficult to see how or why facility owners would discount charges in an anti-competitive way. Under these conditions, maximum prices should be set under Part IIIA.

Should access prices be based on the existing configuration of facilities, or should they try to anticipate technological developments and the like? Would there be dangers in requiring regulators to speculate on future developments when setting access prices? If so, would such developments be better accommodated by reducing the time period for which particular access determinations apply? (p. 34)

If an industry is experiencing rapid technological change, it would be preferable for this to be reflected in more frequent access determinations, rather than in regulators speculating on future developments. In an environment of rapid technological change, the same incentive effects can be achieved within a shorter timeframe, so more frequent determinations should not lead to dampened incentives for facility owners to find cost reductions.

On the other hand, there might be benefit in requiring regulators to consider future developments in that the natural monopoly of 'today' may not be one 'tomorrow'. For example, for particular services, electricity wires, pay-TV cables and telephone lines may all compete in the one market. This point, however, has more to do with whether access should be allowed in the first place than with pricing.

What are the pros and cons of the various asset valuation methodologies available to access price regulators? What lessons have emerged from the methodologies adopted for industry-specific arrangements? (p. 34)

A number of asset valuation approaches are available, viz: Depreciated Historical Cost; Replacement Value; Deprival Value; and Depreciated Optimised Replacement Cost.

No single asset valuation methodology is 'correct' in that once valuation is divorced from the competitive market there are no theoretically indisputable grounds for valuing regulated businesses. The chosen methodology is largely 'purposive', as it will be driven by one's objectives and to a large degree the nature of the infrastructure in question. In this context, it is important to be clear about the purpose of access regulation. For example, one view is that Part IIIA is skewed more towards efficient use of existing infrastructure than maintaining incentives for efficient investment. This potentially creates a bias for relatively 'lower' valuations and static efficiency gains, to the detriment of incentives to invest in infrastructure facilities and dynamic efficiency gains.

Experience to date in Australia has shown that relevant parties have concentrated on the value of the initial capital base (which has been very contentious). This is to be expected at the beginning of a regulatory regime where initial asset values dominate prices and revenues. Also, Australian regulators have generally expressed a preference for 'depreciated optimised replacement cost' (DORC) type methodologies. This has compounded the problem as DORC has proved to be very subjective in practice with large ranges of asset values being estimated (sometimes by the one regulator or consultant for the same set of assets).

Although the rationale commonly provided for DORC is that it is consistent with notions of competition (eg. if assets are valued above DORC, a potential entrant could bypass the facility) another view is that the use of DORC has been driven more by practical considerations. For example:

- All or most of the regulated entities have had a long history of government ownership and assets were developed many years ago. Hence, asset registers in many cases have been incomplete or inaccurate and many of the investments may have been made under very different criteria to those that hold sway today (eg. efficiency). In these circumstances, use of historical cost does not make much sense; and
- DORC is consistent with other elements of the revenue requirement such as operating costs, which are recorded in current dollars.

In any case, the more important issue going forward is the treatment of future investments and assessing whether assets are in excess of requirements (overcapitalisation). The valuation technique is important in that it affects investment returns over time.

The use of DORC essentially places all technological risk on asset owners as they bear the risk of future changes to the prices of relevant inputs or of technological change. Perhaps Australian regulators' preference for DORC is a deliberate attempt to pass on this risk to asset owners, either because of the information asymmetry

involved in determining what an optimal investment is *ex ante*, or simply because it is considered appropriate to place technological risk on asset owners.

In terms of avoiding overcapitalisation, regulators need to ensure that incentives for efficient investment are not distorted. Hence, they need to take into account projected demand growth and lumpiness of investments. This can also be subjective. The Gas Code is notable for having a reasonable process for allowing infrastructure owners to carry forward 'efficient' excess capacity. Specifically, currently used capacity is included only in the current asset base, but as capacity is eventually used, it is progressively added to the regulatory asset base.