THE NATIONAL ACCESS REGIME

QUEENSLAND TREASURY
SUBMISSION TO THE PRODUCTIVITY COMMISSION

JUNE 2001

Table of Contents

1.0 INTRODUCTION 3

2.0 KEY ISSUES 4

2.1 The future role of the national access regime 4

2.2 Objectives and coverage of clause 6 of the CPA and Part IIIA of the TPA 6

2.3 The role of certification 8

2.4 Position of access undertakings under Part IIIA of the TPA 9

2.5 Impact of access regulation on investment in infrastructure 10

2.6 Administrative arrangements 12

3.0 SUMMARY OF POSITION AND SUGGESTED CHANGES TO THE NATIONAL ACCESS REGIME 13

APPENDICES

Appendix 1 Impact of access regulation on private sector investment in infrastructure 14

Appendix 2 Responses to key findings and proposals 20

1.0 Introduction

The Productivity Commission's review of the national access regime is a timely opportunity to review the framework governing third party access in Australia. The experience gained over the past five years of third party access regulation enables us to begin to evaluate the objectives, impact, and effectiveness of the framework.

In general, the current framework is well balanced and does not require any substantial change. However, there is a need to evaluate the application, and interpretation, by regulators of the legislative framework particularly in relation to:

- the framework role of clause 6 of the Competition Principles Agreement (CPA) and Part IIIA of the *Trade Practices Act 1974* ("the Act"), including the interpretation of the criteria for an effective access regime and the role of certification; and

- achieving the objective of encouraging private sector investment in infrastructure which will yield a net economic benefit to society.

The Productivity Commission's Position Paper ("the Paper") has recognised the issue of investment incentive and has raised a number of proposals to ensure this important objective is met and the potential costs of access regulation (in terms of reduced or delayed investment) are minimised. Many of these proposals are supported.

In relation to the framework role of Part IIIA, there are positions in the Paper which are questioned and a proposal for clarification of the role of certification is offered.

The common themes, listed on pages xxi and xxii of the Paper, underpinning the proposed changes to Part IIIA are, with one exception, supported. In particular, the theme access regimes should encourage regulators to lean more towards facilitating investment than short term consumption of services when setting terms and conditions is supported.

The proposed theme common criteria should apply to all access routes within the Part IIIA framework is not supported as it ignores the fundamental structure of the access framework established in clause 6 of the CPA. In particular, it ignores the distinction between the first order requirements (ie. certification requirements) for establishing an access regime and the second order requirements (ie. governing undertakings and arbitrations) for establishing the terms and conditions of access.

2 Key Issues

2.1 The future role of the national access regime

The Paper finds:

- the national regime should be retained;
- there is no reason for a significant change in the balance between the use of access regulation and other policy instruments;
- the national regime operating in tandem with, and providing guidance for, industry-specific regimes, has significant advantages; and
- the regime's guidance role should be strengthened by inclusion of pricing principles and an objects clause.

These findings are supported in the main. A specific access framework is preferred to relying upon existing provisions (or modified versions thereof) in Part IV of the Act regarding anti-competitive conduct and misuse of market power. There is also benefit in retaining a default access regime which establishes a "benchmark" for other industry based or State based access regimes. Part IIIA provides an important example of how the principles for effectiveness, established by the Council of Australian Governments (COAG) in clause 6 of the CPA, may be met.

There are some important qualifications to the endorsement of the Paper's position in relation to the framework/guidance role of Part IIIA.

First, the finding that changes, in the form of pricing principles and an objects clause, are required to strengthen Part IIIA's framework role is supported. However, the reasons given in support of the change - of ensuring "convergence" of industry based regimes and giving guidance on access terms – must be viewed in light of the following matters:

(a) a mechanism for achieving consistency across regimes already exists in the requirement that an effective access regime must comply with the principles set out in clause 6 of the CPA. These principles, established by the COAG and enforced by the National Competition Council (NCC) and the relevant Commonwealth Minister, form a sound framework for the development of access regimes. To ensure all access regimes operate with the same objectives and pricing principles, consideration should be given to inclusion in clause 6 of the CPA of an objects clause and pricing principles.

    Although clause 6 of the CPA ensures consistency across regimes, the Paper's proposal to restrict industry specific access regimes to circumstances where absolutely necessary is supported. While the current balance between industry specific and generic regimes is appropriate and provides scope for competitive innovation in regulatory approaches, the emergence of additional industry based regimes and regulators could increase the already significant administrative, regulatory and compliance costs for industry and its customers.

Generic regimes, based on Part IIIA, with the flexibility to be tailored (eg. by way of access undertakings) to individual industries or facilities, are supported as a means of reducing both regulatory costs and the risk of divergence between regulators and between industries.

(b) the uncertainty as to terms and conditions has been an inevitable outcome of the process of implementation and interpretation of a new regime by regulators. Over time, regulatory convergence, and a body of precedent, in terms of pricing principles and other terms of access is occurring, and will continue to occur.

While legislative parameters (eg. for pricing) can assist in ensuring consistency of terms and conditions across regimes and regulators, there are limitations as to their effectiveness in achieving this objective. Broad legislative guidance is helpful, but it is important also to let the regulators regulate and to permit the process of evolution of regulatory principles to effect convergence. This principle also applies in relation to the development of access regimes in the sense the certification process should not be used by the NCC and the Commonwealth to micro-manage regulators.

(c) another measure for addressing uncertainty about terms and conditions is to permit the development of access undertakings in relation to declared services. The absence in the default regime of an undertaking mechanism to establish terms upfront for declared services may have hindered the potential for guidance on access terms and conditions.

Second, the proposal to align the criteria for the different access routes in order to address a concern which differences in the criteria could increase the possibility of inconsistent determinations seems to overlook the distinct and separate roles of declaration, undertakings, arbitration and certification, and the necessarily different criteria attached to each. It also seems to overlook the 'hierarchy' within the national access framework which underpins the difference in the relevant factors for each "route".

The example used on page xx of the Paper to justify the claim for consistent criteria, namely the criteria for assessing undertakings involve a much greater degree of administrative discretion than the criteria applying to declarations, overlooks the fact two entirely separate questions are involved in these processes. Declaration involves a question of whether coverage should be mandated whereas, in the case of undertakings, the question of coverage has already been voluntarily answered in the affirmative by the owner of the infrastructure. The assessment of an undertaking is asking the quite separate question of what terms and conditions should apply to the infrastructure.

The hierarchy of the national access framework established in clause 6 of the CPA and given effect in Part IIIA is set out below.

Level 1 establishment of access regimes – the setting of regulatory frameworks involves consideration of first order matters which are the clause 6 CPA principles. These broad principles may be met in a number of ways and, amongst other things, requires an arbitrator to be independent and have regard to the matters in clause 6(4)(i). One aspect of a regime is coverage – which may be mandated (eg. by declaration) or by voluntary submission (eg. by submitting an undertaking). If coverage is voluntary there is no need for specified criteria.

Level 2 regulators set terms within the parameters set by a regime – either by way of an access undertaking/arrangement or arbitration determination. Clause 6 (4)(i) establishes the parameters. These are second order matters and necessarily involve a greater degree of administrative discretion than the criteria applying to declarations. The question of coverage has already been determined by the time a regulator considers the terms of access.

Level 3 resolving individual access disputes – may be governed by terms set in undertaking/arrangement. Second order matters are applied to a particular set of circumstances.

This structure must be retained because it recognises the possibility of developing access regimes other than the Part IIIA default regime. This structure is, therefore, a critical backdrop to the interpretation of the role of certification. Any proposal to alter this structure is strongly opposed. Accordingly, the proposal for the same criteria to apply to both access undertakings (setting terms and conditions within the broader framework of a regime) and certification (establishing the parameters for a regime) is opposed. In relation to concerns that inconsistent outcomes will arise under the different routes, it must be remembered the principles of statutory interpretation will ensure, in addressing second order matters, a regulator will be constrained by the first order criteria/matters.

2.2 Objectives and coverage of clause 6 of the CPA and Part IIIA of the Trade Practices Act 1974

Objectives

The Paper proposes the following objects clause be included in Part IIIA:

"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."

This proposal is supported with some qualifications.

As noted by the Paper, there is no stated objective for Part IIIA of the Act or clause 6 of the CPA, although to some degree, the CPA and the Act imply a competition objective. The competition objective is strongly supported. It was always intended, however, the implementation of third party access would be accompanied by due reference to ensure appropriate investment incentives are maintained.

After five years of operation there is significant debate as to whether third party access regulatory outcomes have reflected, or supported, this original investment objective. In particular, there are doubts as to whether regulators are giving full recognition to the risks associated with new investment, especially 'greenfields' projects. In part, this may be due to the fact many of the regulatory decisions to date have related to existing facilities operating in a mature market, with limited opportunities for regulators to formally express their views on rates of return for new investment proposals.

Another explanation may be found in the desire by regulators to "deliver" tangible reform benefits to consumers in the form of lower prices and greater choice. While this objective is important, it is not paramount and must be balanced against the objective of ensuring long term investment incentives.

There would be much to gain from an explicit legislative statement of the objectives of third party access, with specific reference to the objective of encouraging investment in socially desirable infrastructure[1]. Accordingly, the Paper's proposal for the insertion in Part IIIA of an objects clause which makes explicit this objective is supported. This clause should also be inserted in clause 6 of the CPA in order to ensure it is an effectiveness criteria.

The wording of paragraph (a) of the objects clause should however be further refined by inclusion of a form of the words which convey the theme expressed at the top of page xxii of the Paper. That is, access arrangements should encourage regulators to lean more towards facilitating investment than short term consumption of services when setting terms and conditions. These more specific words are essential given the fact the regulators, including the NCC in its certification role, have professed to have had regard to the issue of investment incentive in past assessments. It is arguable their interpretation has not been expansive enough and requires further explicit guidance.

In drafting the objects clause it would also be beneficial to recognise the public interest element to enhancing overall efficiency in essential infrastructure services. The recognition of the public interest is consistent with the CPA which overarches the development of third party access regimes. It is therefore recommended that the objects clause refer to the public interest.

Paragraph (b) of the proposed objects clause should be amended to reflect the fact it is not only industry specific access regimes which are governed by Part IIIA but all access regimes, including generic regimes.

Coverage

The Paper's proposal to narrow the coverage of the national access regime by amending the declaration criteria is supported.

The proposal to exempt, by way of access holidays, new investment from coverage is more complicated and, if adopted, would need careful consideration to avoid further distorting investment signals. The alternative, of recognising within the rate of return (and the length of review periods) the risks faced by industry (and its financiers) in relation to new investment is supported.

The Paper's proposal third party access should continue to apply to vertically integrated access providers is supported. The problems associated with monopoly supply of services still exist regardless of whether a provider is vertically integrated. There is still an incentive to restrict output or charge monopoly access prices or to act collusively with suppliers in related markets. These problems might be addressed via Part IV of the Act, but not as effectively as under Part IIIA.

[1] Socially desirable investment is the level of investment where the benefits (including spillover effects) to society outweigh the costs. Regulated returns should be set at a level which will elicit this level of investment while still yielding tariff outcomes which fall within a reasonable range.

2.3 The role of certification

In accordance with clause 6 of the CPA, section 44M of the Act permits a State or Territory to make a written application to the NCC asking for a recommendation to the relevant Commonwealth Minister that a regime for access to a service be certified as "effective". In making a recommendation, the NCC is to only have regard to the relevant principles in clause 6 of the CPA. Similarly, the Commonwealth Minister, in making his or her decision, must only have regard to the CPA principles.

The objective of certification is to ensure the fundamental principles for an effective regime are incorporated in an access regime – in effect, ensuring a consistent minimum standard applies. As noted in section 2.1 above, the list of principles in clause 6 of the CPA provides a good framework for establishing effective access regimes.

There is a question, however, as to whether effectiveness should be conditional upon the terms and conditions of access determined by a regulator, or the regulatory practice adopted by a regulator, in order to satisfy the clause 6 principles. How much of the detail of access terms and regulatory practice should be left to the relevant regulator?

The answer lies in:

- the hierarchy of the access framework as outlined in section 2.1. The effectiveness of a regime lies in the way it addresses the first order broad principles set out in clause 6 of the CPA. Certification should, therefore, focus on the first order matters for establishing an access regime; and

- the standard set by Part IIIA itself. The Paper seems to endorse the default regime, with perhaps some modifications relating to objects clause, pricing principles and access undertakings, as an effective benchmark regime. This interpretation can be implied in paragraph (b) of the proposed objects clause which states the object of Part IIIA is to provide guidance to other access regimes.

Part IIIA provides several avenues (ie. declaration or submission of either an undertaking or industry code) by which a service may be covered but essentially leaves the determination of the terms of access and regulatory practice to the Australian Competition and Consumer Commission (ACCC) within the constraints [especially clause 6(4)(i)] established by clause 6 of the CPA. Decisions by the ACCC are reviewable to ensure relevant matters have been considered and procedural fairness applied. The effectiveness of the regime is not conditional upon the outcome of an access arbitration (in the case of a declared service) or the assessment of an access undertaking (in the case of an undeclared service) by the ACCC.

It follows that any regime modelled on the default regime, or which is at least as extensive, is effective. Implicit in this observation is the understanding that the effectiveness of the default regime, or any regime, does not rest upon the determinations made, or upon the terms of undertakings approved by the regulator – in this case, the ACCC.

The observation also makes it clear it not essential for a regime to be as detailed, for example, the industry specific regimes in order to be an effective regime. The objective of certification should be to ascertain whether the regime establishes an appropriate broad framework, within which a regulator operates, which places constraints upon the regulator as set out in the principles of clause 6 of the CPA, and which provides administrative review of any decisions of the regulator. Effectiveness should not require an assessment of the terms of access set by the relevant regulator.

This is especially the case where a regime is based closely on the generic regime contained in Part IIIA and administered by a regulator is independent of owners and Government. The certification process should not be a mechanism to:

- establish the "second order" access principles which may be utilised by an independent regulator in setting the terms of access for a specific service or facility; or

- effectively, "second guess" a regulator which is operating under a regime which contains provisions which give effect to the broad clause 6 principles.

As noted in section 2.1, there is a form of regulatory convergence occurring by way of a growing body of accepted regulatory principles and practice, fostered and supported, in part, by the Utility Regulators Forum which promotes transparency and consistency as key regulatory objectives. The possibility for regulatory divergence is tempered by accepted regulatory principles in the areas of asset valuation, pricing principles and other aspects of access regulation, at least in relation to the regulation of existing assets in mature markets. There is limited scope for a regulator to produce regulatory outcomes which are outside an acceptable range.

Accordingly, it is suggested a provision should be included in Part IIIA which specifies the effectiveness of an access regime is not dependent upon the terms and conditions of access established in undertakings and arrangements where this role has been given to a regulator/arbitrator constrained by the principles and factors in clause 6 of the CPA and administrative appeal is available as prescribed in clause 6 (4)(h).

Effect of certification

The purpose of certification is to provide certainty for all stakeholders. Where industry based or state based regimes are certified as effective regimes, the potential for Part IIIA to apply (either via the declaration route or the undertaking route) should be extinguished. Currently, the declaration route is not available for services the subject of an effective regime. In contrast, the potential still exists for an owner to submit an undertaking under Part IIIA in circumstances where the service provided by the infrastructure is covered by a certified regime. While this avenue exists, the objective of certification is "undermined". Accordingly, a provision should be included prohibiting the lodgement of an undertaking in relation to a service that is the subject of a certified regime.

2.4 Position of access undertakings under Part IIIA of the Trade Practices Act 1974

At present, Part IIIA of the Act:

- permits the owner of a service to voluntarily lodge an access undertaking with the ACCC only where there has been no declaration under Part IIIA;

- does not permit the ACCC to require an access undertaking in relation to a declared service; and

- permits the lodgement of an access undertaking in relation to a service which is declared under a certified access regime.

The Paper's proposal the existing restriction on lodgement of undertakings in relation to declared services be removed and provision should be made for the voluntary lodgement of undertakings by owners for both declared and non-declared services, is supported. The prohibition on undertakings in relation to declared services has effectively ruled out an important mechanism for creating greater certainty and guidance as to the terms and conditions of access. The Paper's proposal of moving to arbitration 30 days after declaration as a means of establishing terms is another, more adversarial, method of achieving certainty of terms. It also appears to contradict the proposal effectiveness is not dependent upon the degree to which terms and conditions are set by negotiation or regulation or arbitration.

The proposal for a person other than the owner or operator of a facility to lodge an undertaking application is not supported. The imposition of access regulation is not insignificant and should not be imposed lightly. There already exists an avenue – declaration - for a person other than the owner or operator to seek coverage of a service. If the concern is to ensure access terms and conditions can be established without recourse to arbitration, then it is more appropriate the declaration avenue be complemented by giving the ACCC a power to require an undertaking in relation to a declared service. It seems inconsistent for the Paper to argue against a proposal to give the ACCC this power, yet seek views on how persons other than the owner or operator may lodge an undertaking application.

The proposal for a merits review of access undertakings is strongly opposed on the grounds the potential costs (through lengthy legal processes and delaying tactics) will more than outweigh any benefits. The costs and time involved in establishing and approving access undertakings are substantial and the introduction of merits review will unduly extend the process. The avenue of appeal by way of judicial review, or other administrative remedies, is sufficient to ensure a regulator confines its deliberations to relevant considerations and conducts a process based on natural justice and fairness.

As noted in section 2.3, the possibility an undertaking may be lodged even where a service is the subject of a certified access regime has the potential effect of undermining the certification process and could result in delaying tactics and forum shopping by the owners of a service. As with Part IIIA, access undertakings may be lodged under a certified regime. The provisions allowing the lodgement of access undertakings in relation to a service which is declared under a certified regime should be removed. Accordingly, the Paper's proposal to retain these provisions is strongly opposed.

2.5 Impact of access regulation on investment in infrastructure

While there is a need to ensure competition benefits for end-consumers in the application of third party access principles there is also a need to encourage new investment. It is important regulators signal a willingness to recognise the different risk characteristics inherent in greenfields projects.

As time progresses, third party access regulation, or the threat of regulation, appears to be having an effect on private sector views on investment in infrastructure. Appendix 1 outlines some anecdotal evidence compiled by the Queensland Treasury Corporation into the impacts of regulation on institutional investor decisions.

On a more direct level, in Queensland, the following tenders for either the purchase, or lease, of Government owned infrastructure, or for the private sector construction and operation of infrastructure have been affected by investor uncertainty about regulation:

- tender for the sale of three central Queensland water pipelines;
- tender for construction and operation of the Brisbane Light Rail;
- proposal for the construction and operation of the Nathan Dam in the Dawson Valley; and
- tender for the lease of the Dalrymple Bay Coal Terminal.

Without attributing to a particular project, the effect is evidenced in:

- discounting of asset values;
- need for upfront certainty in relation to whether an asset will be regulated and, if so, the expected regulatory positions on pricing, revenue;
- decisions not to invest; and
- the possibility of unwieldy hybrid arrangements where Government has to step-in (and carry the risk) on capacity expansions to ensure timely investment.

Clearly, there is a need for safeguards against inefficient investment decisions and monopoly pricing and practices, and a need to deliver fair and reasonable prices to end-users. However, this should be balanced against the potential for market driven investment in infrastructure to be the catalyst for broader economic development and the potential costs to society in a reduction in investment. As far as possible, the market should determine whether and when investment should occur.

When market-based returns (based on the riskiness of a project) are constrained by a regulated return, some projects may become non-commercial, even though they may still be economically viable from society's perspective. This may place a greater obligation on government to fund a large part of crucial economic development, with consequences for the level of public borrowing and the transfer of funds from other areas of public expenditure.

Essentially, a regulator should consider all the economic benefits to society of a project which might be undertaken by the private sector. The regulator should seek to set a regulated rate of return which is equivalent to the hurdle rate of return which will achieve a level of investment where the economic benefits (including spillover effects) of the investment exceed the costs of the investment to society.

In this respect, the Paper's proposal for an objects clause and pricing principles which refocus regulators on investment incentive is supported. As noted in section 2.2, the wording of the objects clause should be refined to make it explicit that regulators should lean toward facilitating investment as opposed to short term consumption.

The manner in which regulators might give effect to the objects clause and provide some regulatory incentive for new marginal investment projects is, however, problematic. The Commission recommends the inclusion of access holidays, implemented via a null undertaking, such that access would be restricted for a defined period of time. Another alternative would be to allow additional security (eg. longer review periods) and rewards (returns at the mid to higher end of a reasonable range) for socially desirable investments[2] which exhibit higher risk characteristics[3]. The practical difficulty with both approaches is regulators may consider the classification problems associated with identifying eligible marginal investments too difficult, thereby causing a natural reticence on the part of regulators to exercise their discretion in this regard.

To assist regulators in the identification of eligible new marginal investment projects, it is suggested the ACCC could be requested to prepare criteria for the identification of new marginal investment projects. The development of a unified set of eligibility criteria would ensure regulators adopted a consistent approach to the assessment of new marginal investment projects.

2.6 Administrative processes

The concern institutional arrangements are cumbersome and administrative processes are time consuming does not recognise the complexity of access regulation. It is difficult to truncate processes of natural justice and due consideration. Some of the Paper's proposals in this respect (eg. merits review of access determinations and access undertakings) seem to contradict the objective of streamlining the processes.

The proposal to remove Ministerial involvement is not supported because public interest matters remain within the domain of elected governments.

The proposal that there be a single regulator (probably the ACCC) to regulate all aspects of Part IIIA, including certification, is not supported. Apart from the desire for Ministerial involvement (see above paragraph), the CPA gives the States and Territories the right to develop access regimes and to have State based regulators. If the proposal extends to these regimes, the existence of only one regulator may reduce the rigour and robustness of the regulatory competition and innovation associated with multiple regulators.

[2] An investment is socially desirable if the social returns to the investment exceed the social opportunity cost of that investment (ie. after internalising the externalities associated with that investment, it is still economically efficient).

[3] A regulator should select a rate of return within the reasonable range of returns that coincides with the rate at which the investment becomes privately profitable for the investor.

3.0 Summary of position and suggested changes to the National Access Regime

1. No wholesale changes.

2. Support retention of existing Part IIIA as opposed to relying upon Part IV (or a modified version thereof).

3. Support explicit statement of the objective of access regulation with reference to encouraging private sector investment in socially desirable infrastructure.

4. Support narrowing of coverage by amending the declaration criteria to require that access result in a substantial increase in competition.

5. Clarify the role certification to ensure effectiveness is not conditional upon the regulator's decisions in relation to access undertakings and terms and conditions.

6. Prohibit access undertakings in relation to services declared under certified access regimes.

7. Undertakings to be permitted under Part IIIA regardless of declaration. The ACCC should have the power to require an undertaking in relation to a declared service.

8. Continue to apply third party access to non-vertically integrated providers.

9. Reject proposals for merits review of regulator decisions on access undertakings and arbitration determinations.

10. Limit industry specific regimes to circumstances where absolutely necessary.

11. Reject proposal for alignment of criteria relating to declaration, undertakings, arbitrations and certification.

Appendix 1

Anecdotal evidence of the impact of regulation on private sector investment in infrastructure

As an input into this submission, the Queensland Treasury Corporation conducted discussions with four domestic equity institutional investors, two institutional debt investors and the Australian Council for Infrastructure Development to assess:

- the impact of regulation on the incentives to invest in infrastructure, in particular the factors that investors take into account in determining a hurdle rate of return; and
- the level of funds being allocated to regulated infrastructure assets.

In summary, the findings were, investors feel regulation:

- restricts an owner's ability to manage the cashflow of an asset in order to accommodate fluctuations in the market;
- is currently being implemented with an asymmetrical approach to allocating risks in favour of the consumer;
- is, as a result of the above factors, increasing regulatory risk and, therefore, increasing the cost of capital; and
- flowing from a combination of the above factors, is reducing the attractiveness of investment in Australian infrastructure within a global investment market.

Sections A1.1 and A1.2 elaborate on these findings.

A1.1 Impact of regulation on the factors an investor takes into account in determining hurdle rate of return.

A key concern regarding the current regulatory approach to determining rates of return lies in whether the regulators adopt a sufficiently "commercial" approach to determinations which adequately factors in the riskiness of a new investment. While regulators may utilise the same methodology [ie. Capital Asset Pricing Methodology (CAPM) and Weighted Average Cost of Capital (WACC)] private (and public sector) investors use in determining a hurdle rate for investment, it is arguable, in fact, investors will also rely on "gut instinct" and factor in an additional margin to allow for "contingencies" before arriving at a final rate. It is also arguable this margin is increasing as a result of regulatory risk.

One method of calculating the cost of capital for investment in regulated infrastructure assets is the WACC methodology. The main factors used in calculating the WACC are the cost of equity and the cost of debt. The cost of equity is determined by assessing the riskiness of the infrastructure asset whereas the cost of debt is largely determined by the credit rating of the asset.

Institutions stated regulatory risk is an important factor used in determining the cost of capital for investment in a regulated infrastructure asset. Regulation may affect the cost of debt through its impact on the credit rating and may affect both the cost of debt and cost of equity due to its effect on the variability of an infrastructure asset's cash flows.

(1) Impact on the cost of debt

The cost of debt, whether bank debt or a capital market issue, will be largely affected by the credit rating of the debt issue. Institutions stated regulation can create uncertainty and may have a negative impact on the perceptions of debt providers.

Standard and Poors[4] (S&P) has detailed criteria it utilises to determine the effect of price regulation on the credit rating of a utility. S&P states if regulation affects the revenue generating ability of an asset, the rating of the asset may be affected. They also state credit ratings may be affected by the level of flexibility owners have to manage the risks inherent in the regulatory regime. Regulation is an important consideration, taken into account when determining the rating of an entity operating in a regulated environment.

Some of the issues that S&P reviews when assessing a regulatory pricing regime are:

- stability - relates to the term of the price path, the type of pricing regime (price cap or revenue cap) and its effect on cash flow volatility. Price caps are seen to be a slight weakness as they may limit the ability of an owner to manage cashflow volatility;

- timeliness - refers to the ability of the owner of the asset to take timely action to respond to changing operating conditions;

- transparency - is concerned with the regulatory policies, board appointments to the regulator and the experience of the regulator;

- fairness - mainly relates to reset risk where the rate of return is reviewed and efficiency gains may result in large reductions in price; and

- flexibility - refers to the ability of the asset to respond to external events.

Examples of the possible effect of regulation on ratings of entities include the lowering of S&P's credit rating of Railtrack in the United Kingdom, partially as a result of tighter regulation and a price review. Also in the United Kingdom, six water companies have been put on a credit watch with negative implications as a result of the expectation the regulator will apply a one off reduction in prices of between 15% and 20%.

Two of the other factors that are considered by debt providers in determining the cost of debt for entities operating in a regulated environment are the type of industry (regulatory risk may vary between industries) and the location of the project (State and Commonwealth regulators may apply different methodologies).

[4] Utility Price Regulation: A Credit Perspective, February 1999

If a regulatory regime does not adequately address the above factors, particularly by allowing an owner sufficient flexibility to manage risk (or to be compensated for risk), there may be an adverse effect on the asset's cost of capital.

(2) Impact on the cost of equity

Discussions with institutional equity investors highlighted several different types of regulatory risk which are perceived by institutions to affect the equity cost of capital. In summary, these are:

- reset risk;
- asymmetrical nature of returns;
- lack of timeliness;
- use of market capitalisation rather than asset base to calculate returns;
- uncertainty about returns which may be earned on new investments;
- use of an inappropriate benchmark (ie. listed corporations) when assessing riskiness;
- use of revenue capping versus price capping.

Reset risk

Reset risk occurs when an asset is nearing the end of a regulatory term and will be subject to a price review. Institutions stated higher equity returns were required to compensate for the risk that prices would be subject to a one off price reduction and the regulated rate of return may also be lowered.

Institutions stated regulatory risk in the Australian context also stems from the application of performance based regulation where the common Consumer Price Index (CPI)-X approach provides an additional risk to the investment in regulated infrastructure. Performance based regulation is viewed as being more risky than cost based (rate of return) regulation as the asset may not be able to achieve the performance targets set by the regulator (even when operating efficiently).

This view is supported by the World Bank[5] in an article which examines the level of market risk in the different types of regulation. The market risk is measured in the cost of equity using the beta in the CAPM. The research shows there are significantly lower beta factors for regulated corporations in the United States where rate of return regulation is applied compared to regulated corporations in the United Kingdom where performance based regulation is applied. The author acknowledges there are differences between markets which may account for some of the difference.

[5] Regulated Structure and Risk and Infrastructure Firms, December 1996

Asymmetrical nature of regulation

Institutions identified the asymmetrical nature of returns as an impediment to investment in regulated assets. The asymmetry occurs where a regulatory regime does not effect an equal sharing of revenue benefits between users and the investor, and where the benefits are usually shared in favour of the users. Investors perceived they normally wear the brunt of any negative impacts (eg. volume risks) which the asset encounters, with users being sheltered from these negative impacts.

A research article by Oxford Economic Research Associates[6] examines the asymmetry that may occur as a result of regulation for which investors will require additional returns for the risk that is not captured by the beta in the CAPM. The article refers to evidence that the premium above the CAPM cost of equity could be between one and two percent. The research highlights regulation may result in asymmetric distribution of returns, which results in the CAPM not capturing all the risks of the company. Some of the features of regulation that may cause this asymmetry are the exclusion of assets from the asset base by a regulator, the claw-back of past excessive returns and valuation of assets when transiting from a regulated market to a competitive market.

Lack of timeliness

Institutions advised regulation attempts to replicate a competitive market, however most regulated assets do not provide for timely adjustment to changes in economic and operating conditions. Airport regulation provides an example of a situation where asset operators are provided with some scope to adjust to changing economic conditions, but are still subject to medium term CPI-X conditions. The level of X is sometimes not appropriate given changing economic conditions. Institutions often look for Government concessions or other guarantees to alleviate the risk that revenue would not be achievable.

Use of market capitalisation rather than asset base

Returns are sometimes calculated using data sourced from listed corporations where the returns are calculated using the market capitalisation of the corporation rather than the asset base. If the asset base were used to calculate the returns, higher returns would be evident.

Returns that may be earned on new investments

Another area of concern for institutions is the uncertainty surrounding new capital investment and the return which can be achieved on new investment. Institutions advised regulators may change the pricing principles which are applied to regulated assets and this creates further uncertainty for investors.

Institutions stated regulators are calculating rates of return lower than the institutions' required rates of return. This resulted in either an increase in the investor's equity cost of capital or the forecast revenue stream associated with the asset being lowered to take account of regulatory rate of return risk.

Institutions stated they are only seeking a fair outcome under regulation and an appropriate risk adjusted return.

[6] Regulatory Risk, June 1998

Use of listed corporations as a benchmark for riskiness

Investor returns from investment in unlisted infrastructure are mainly generated through dividends and there is significantly lower liquidity from which investors can achieve returns through capital gains when compared to listed securities. In the CAPM, the beta is calculated using listed securities which are subject to higher levels of liquidity and where the beta can be adjusted for thin market trading. For unlisted corporations, the difference in liquidity between listed and unlisted corporations needs to be accounted for by applying a premium to the cost of capital.

Revenue capping versus price capping

Some institutions did highlight the fact regulation can be good for the investor and provide more predictable and stable revenue. This, however, depended on the type of regulation. Revenue capping rather than price capping results in a lower required risk adjusted return because it gives a "guaranteed" revenue stream and gives the owner greater flexibility to manage cashflows. Price capping has the potential to expose the owner to a range of risks including volume risk.

In summary, regulation would appear to have resulted in an increase in the cost of capital required by institutional equity investors for investing in regulated assets. Accordingly, one likely implication of regulation is there will be a reduction in private investment in infrastructure, including extensions or expansions of existing facilities, which is subject to regulation.

A closer examination of the impact of regulation on investment perceptions is provided in section A1.2 below.

A1.2 Anecdotal evidence of the impact of access regulation on investment

There is anecdotal evidence that the prospect of regulated returns is having the effect of lowering the level of investment in regulated infrastructure. The competition for investment funds is global. Global investors will look at a range of projects around the world before deciding where to allocate funds. In a comparison between an investment which is subject to regulated returns which may not adequately reflect the riskiness of the project or take account of commercial factors and a non-regulated investment in another country, it is possible investors will allocate funds elsewhere.

Most of the equity institutional investors spoken to specialise in infrastructure assets. The Australian institutional investors stated they are limiting the amount of funds they are allocating to regulated assets by either not investing in regulated assets or by reducing the amount of funds previously allocated to regulated assets. Moreover, they were only considering regulated assets where the purchase price provided an adequate return to compensate for the regulatory risk or where the asset generated revenue from both regulated and unregulated sources. Where revenue is generated from both regulated and unregulated sources, unregulated revenue was required to be the major source of funds.

Most institutions stated they are attempting to create a portfolio of regulated and unregulated assets thereby limiting their exposure to regulatory risk. They stated limiting investment in regulated Australian infrastructure assets may lead to a higher proportion of funds being invested in international infrastructure assets.

In summary, institutional investors are currently reluctant to invest in regulated infrastructure assets due to the perceived uncertainty created by regulation. Institutions stated that only under certain conditions would they invest in regulated assets (ie. where assets which provide returns to compensate for the higher risk or assets which do not achieve returns solely from regulated sources).

APPENDIX 2

RESPONSE TO KEY FINDINGS AND PROPOSALS

P stands for "Proposal"
F stands for "Finding"

Key finding or proposal	Queensland Treasury comment
The future role of the national access regime	
F4.1 There is no reason for a significant change in the balance between the use of access regulation and other policy instruments addressing access matters.	Support
F4.2 Some changes are required to strengthen Part IIIA's framework role and encourage convergence in the industry-specific regimes.	Support with qualifications as noted in section 2.1 of this submission.
Objectives of Part IIIA of the TPA	
P5.1 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."	Support with amendments proposed in section 2.2. Insert also in Clause 6 of the CPA.
F5.1 The national access regime should not be used to pursue distributional outcomes.	Support.
The coverage of Part IIIA	
P5.2 There should be explicit recognition that Part IIIA covers services provided by both vertically integrated and non-integrated facilities.	Support
F5.2 Part IIIA should continue to address market power arising from natural monopoly technologies, however, in specific circumstances (eg telecommunications) it may be appropriate to address additional sources of market power.	Support
F5.3 The current exclusions from Part IIIA are appropriate and should be retained.	Support

Key finding or proposal	Queensland Treasury comment
The inclusion of pricing principles in Part IIIA	
P5.3 Pricing principles should apply to arbitrations, assessments of undertakings and evaluations of effectiveness.	Support
Part IIIA declaration criteria	
P6.1 Criteria should be modified to require that; access promote a *substantial* increase in competition; and, that it be uneconomic for anyone to develop a second facility.	Support
P6.2 More extensive changes to the declaration criteria.	Not support. Too disruptive to adopt a major change to declaration criteria.
Information provision by the service provider of a declared service	
P6.3 Provider to give sufficient information to enable the access seeker to engage in effective negotiation.	Support. See relevant provisions of QCA Act.
Modifications to the negotiate-arbitrate arrangements	
P6.4 Arbitration to commence 30 days after declaration unless both parties notify ACCC that a settlement is likely.	Not support. Provides little opportunity for negotiation and for access undertaking process to occur.
P6.5 Part IIIA to contain a provision that the aim of arbitration is to promote the efficient use of, and investment in, essential infrastructure.	Support with additional words as suggested in section 2.2 of the submission. However, it is arguable that this is superfluous if the objects clause is inserted.
P6.6 The ACCC should limit its involvement to matters in dispute. Where matters agreed between parties are subject to reassessment by ACCC, it should explain its reasons for doing so.	Not support. ACCC should not be permitted to reassess matters which have been agreed between parties. ACCC should not be limited to matters listed, otherwise parties may keep returning to arbitration.
P6.7 Introduction of non-efficiency matters by ACCC when arbitrating should be explicit and supported by reasons.	Support. Public interest matters will necessarily have to be factored into a regulator's decision.
P6.8 When arbitrating the ACCC should be able to require interconnection but scope to require extensions of a facility should be removed.	Not supported. Current wording of clause 6 is appropriate and must be retained. The capacity for a regulator to require extensions is critical. Agree with NCC that capacity expansion should be included.

Key finding or proposal	Queensland Treasury comment
Extension of certification arrangements to all industry access regimes P7.1 Commonwealth Government should submit its access regimes for certification.	Support
P7.2 Privately provided services subject to statutory access regimes should be assessed against same effectiveness criteria as publicly provided services.	Support. This is currently the situation under Part IIIA and clause 6 and no change is needed. As a general comment, it is preferable that an access regime should apply to both private and public owners.
Principles for assessing the effectiveness of existing access regimes P7.3 Principles should be included in Part IIIA.	Not supported – these principles are set by COAG and should remain in clause 6 of the CPA.
P7.4 Proposes significant changes to the effectiveness criteria and suggests that the degree of reliance upon negotiation relative to arbitration and regulation to set terms and conditions should not be a part of the effectiveness test.	The reframed principles are not supported. The existing principles are sufficient with inclusion of proposed objects clause. The proposal regarding the relative importance of negotiation as opposed to regulation to set terms and conditions is supported.
Part IIIA access undertakings P7.5 An access provider should be able to lodge an undertaking after declaration.	Support – should also include a power to ACCC to require an undertaking.
P7.6 Criteria for assessing undertakings should be aligned, as far as practicable, with those applying to arbitrations and effectiveness.	Not support. The factors relevant to establishing an access regime (certification) are different to the second tier factors that a regulator must have regard to in determining an undertaking and in determining dispute.
F7.1 The scope for undertakings to be submitted in relation to infrastructure the subject of a certified access regime should be retained.	Not support – refer to section 2.4 of this submission. This proposal runs counter to the theme of streamlining the regime and making it administratively simpler. It also undermines the concept of certification.
Access pricing principles P8.1 Principles 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;	Support

Key finding or proposal	Queensland Treasury comment
• 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."	
Price cap arrangements	
F8.1 Greater use of productivity–based approaches for setting price caps. Regulator should give priority to developing external productivity benchmarks.	Not support – the form of regulation (ie revenue cap or price cap) should be left to the regulators.
P8.2 Explicit provision for productivity-based approaches for setting price caps in the criteria for certification.	Not support – leave to regulator.
Future Part IIIA decision making and administrative arrangements	
P9.1 Decision making role of Ministers should be ended. Should be responsibility of regulatory bodies. If Ministers' role is retained it should be modified as in proposals 9.3 and 9.8.	Not support. Public interest matters remain within the domain of elected governments. Provides important review mechanism for regulator.
P9.2 Single regulator (ie ACCC) for regulating all aspects of Part IIIA, subject to relevant appeals processes.	Not support – CPA gives States the right to develop access regimes. One regulator would also remove the rigour and robustness of regulatory competition/innovation associated with having more than one regulator.
P9.3 Ministers decisions (re declaration and certification) should be made within 60 days.	60 days is short given the need for Minister to review all material independently and consult. 90 day minimum is preferred.
Part IIIA appeals arrangements	
P9.4 Provision should be made for full merits review by Australian Competition Tribunal of decisions on undertaking applications.	Not support – refer section 2.4 of the submission.
P9.5 Appeals against decisions to declare should be abolished, but retained for rejected declaration applications and arbitration determinations.	Not support. Unfairly biased in favour of access seekers and against owners of infrastructure. Each party should have same rights of appeal.
Transparency arrangements	
P9.6 Provision should be made for public comment on application for declaration and certification, and proposed access undertakings, except	Support.

Key finding or proposal	Queensland Treasury comment
where inappropriate to do so.	
P9.7 If Ministers are removed from decision making, regulators should be required to publish reasons for their decisions on declaration, certification, and undertaking applications.	Support even if Ministerial involvement is retained.
P9.8 If Ministers retain responsibility for declaring services and certifying existing regimes, they should publish reasons for their decisions. 60 day time limit on decisions otherwise deemed to have accepted regulator's recommendation.	Certification – S44N requires reasons to be published. Declaration – S44H requires reasons to be published. No deeming of acceptance of regulator's decision re effectiveness.
P9.9 ACCC should be required to publish post-arbitration reports.	S.44V already requires ACCC to publish reasons for its determination. This is sufficiently broad.
Removing overlaps with other parts of the TPA P10.1 The terms and conditions of the following Part IIIA access arrangements should be exempt from exposure to Parts IV and VII of the Trade Practices Act: • Arbitrated determinations for declared services; • Agreements reached under certified regimes with the involvement of the relevant regulator; • Agreements negotiated under accepted undertakings; and • Private agreements for declared services covered by registered private contracts.	Not support. It may still be possible for a breach of Part IV to occur. Access regulators are not regulating competitive conduct except to ensure access provider is not hindering access. There are many possibilities for misuse of market power to occur. The argument that it is difficult to comply with 2 parts of the TPA is not justifiable. If this were the case, most corporations would have to be exempted from Part IV in all spheres of activity. If, in fact, the access framework is a safeguard against anti-competitive conduct, then parties to access agreement should have limited exposure to Part IV.