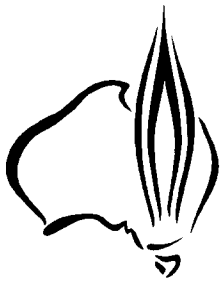

The Australian Gas Association

Submission to the Productivity Commission

Review of the National Access Regime

Response to Productivity Commission Position Paper

8 June 2001

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Executive Summary

The Australian Gas Association (AGA) welcomes the Position Paper issued by the Productivity Commission ('the Commission') as a comprehensive and positive examination of the challenges facing infrastructure owners and regulators under the current national access regime.[1]

The Productivity Commission review comes at an important time for the natural gas industry. Given the significant progress in implementation of the National Competition Policy reforms since 1993 and the experience since 1997 with the National Third Party Access Code for Natural Gas Pipeline Systems ('the Code') the AGA believes it is an appropriate time to revisit access regulation and determine whether there are improvements that can be made. The operators of regulated gas pipelines and distribution networks consider that their experiences with the Code contain some important lessons for the future of the national access framework.

The AGA also welcomes the Commission's support for the contention of regulated gas businesses that current regulatory outcomes have not sufficiently recognised the need to encourage infrastructure development. The nearly four years since the beginning of the operation of the Code have demonstrated that as an instrument it is cumbersome, time-consuming, and costly, both for industry participants and final consumers.

The AGA strongly supports the inclusion of access pricing principles in Part IIIA of the Trade Practices Act ('Part IIIA'), setting out the need for access pricing to lead to adequate investment in infrastructure services and appropriate returns. The AGA considers that action on effective access pricing principles is potentially the single most important recommendation of the Position Paper.

Further, the AGA supports the inclusion of an objects clause in Part IIIA. A well-drafted objects clause may help to ensure that all parties affected by infrastructure regulation have a common understanding of a key aim of access regimes – that is, promoting economic efficiency by promoting efficient investment in essential infrastructure services. A single harmonised objects clause could also assist regulators who face a number of inconsistent lists of objectives across such instruments as Clause 6 of the Competition Principles Agreement (CPA) and a variety of industry-specific codes.

The AGA has, however, several concerns regarding the Commission's recommendations to end Ministerial involvement in decision making under Part IIIA. While the role of Ministerial decision making under Part IIIA does create the potential of delays in regulatory processes, this involvement is nonetheless warranted. Concerns relating to potential delays in decision making should be addressed through binding time limits on regulatory processes. Ministerial representation in regulatory decision making is important from the point of view of public accountability. It is also important that given the generic assessments of public interest that current legislation

[1] The AGA and many of its regulated network and pipeline members are also co-sponsors of the Network Economic Consulting Group *Joint Industry Submission*, June 2001

requires, and which ought to be part of future access regimes, an identifiable public representative makes a transparent decision. Conversely, regulators with specific mandates under legislation should not be put in the position of making unappealable 'public interest' decisions with significant national consequences.

In a more general context, the AGA believes the current national third party access regime has led to increased uncertainty for investors in significant infrastructure. Access regulation has increased regulatory risk, while creating asymmetric risk for proponents of new gas pipelines and network expansions. Investors in new infrastructure assets bear all market risks associated with a failure of a project to achieve demand forecasts. If the project is successful, however, investors face the prospect of having project returns capped by regulated terms and conditions for third party access. In addition, access regulation in the gas pipelines and distribution network sectors has had insufficient regard to the long term benefits to consumers of the availability of new infrastructure services, and the reliable delivery of existing services. As the Position Paper notes, this imbalance between consideration of the long and short-term interests of consumers and potential consumers has the potential to lead to costly under-investment in key infrastructure services.[2]

The cost of regulation for operators of gas pipelines and distribution networks has been substantial under the industry-specific Code. For gas transmission pipelines alone, the AGA estimates that the cost of preparing access arrangements has exceeded $13 million. The Code has also required service providers under the Code to devote considerable management and financial resources to work on the many complex regulatory instruments and requirements which the Code involves. The AGA notes that the cost of regulation also includes the cost to consumers and taxpayers of the substantial resources regulatory agencies require for the carrying out of their functions under the Code. Other significant costs of the Code include the opportunity cost of the resources that regulated gas businesses expend on regulatory affairs, and the deterrent to productive investments arising from regulatory discretion in the Code.

It is of critical importance that governments consider and implement the Commission's proposals in a timely manner. It is likewise imperative that the Commission's conclusions about the inadequacies of the current national access regime, and recommendations on measures necessary to enhance investment in infrastructure assets to meet the long-term interests of consumer, be recognised by the planned reviews of industry-specific regimes in gas and electricity.

The Commonwealth Government has announced its intention to pursue a review of energy market reform, with an associated review of the operation of the third party access regime for gas pipelines and distribution networks. The AGA considers that these reviews should seek to incorporate the substantial progress made on key issues relating to third party access regimes in the Commission's review. In order to promote this outcome, the AGA recommends that the Productivity Commission conduct the review of the industry-specific access regime for gas pipelines and distribution networks.

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[2] Productivity Commission Position Paper *Review of the National Access Regime*, March 2001, p.61

Introduction

This submission deals mainly with responses to specific proposals and requests for further information raised in the Commission's Position Paper released in March 2001. More general comments on the AGA's concerns with the current third party access framework are contained in the AGA's first submission of December 2000 and the two Network Economic Consulting Group submissions to the Commission's review of the national access regime.

The AGA encompasses all sectors of Australia's natural gas industry, including operators of regulated gas pipelines, distribution networks and gas retailers. This submission represents the views of AGA members operating regulated gas distribution networks and pipelines, and does not reflect the views of gas producer members.

Response to Commission's Proposals

Objectives of Part IIIA

The AGA supports the inclusion of an objects clause in Part IIIA which stresses the need for the efficient use of, and investment in, infrastructure assets. The AGA also supports an explicit recognition of the framework role that Part IIIA plays in relation to industry-specific regimes such as the National Third Party Access Code for Natural Gas Pipeline Systems.

The Commission correctly identifies the risks of multiple access regimes operating without a set of clear guiding objectives. This trend runs contrary to recent developments in legislative practice, in particular, the clear identification of objectives underlying legislation and regulation. An objects clause which highlighted the underlying objectives of access regimes would be a valuable guide to regulators. Regulators currently face a variety of overlapping, inconsistent and confusing sources for the public policy objectives they are charged with pursuing.

An objects clause for access regimes should not include references to particular distributional outcomes. Third party access regimes are not the appropriate means through which to seek distributional outcomes. Distributional outcomes should be pursued by targeted, transparent mechanisms that do not distort long-term investment decisions in the infrastructure sector. One such mechanism is the explicit public funding of distributional goals through targeted community service obligations.

Inclusion of pricing principles in Part IIIA

The AGA strongly supports the inclusion of clear access pricing principles in Part IIIA.

The existing principles within Part IIIA, such as those contained in s 44X, are not sufficient. In addition, the variety of principles which regulators must contend with (for example in s 44X, the Code and Clause 6 of the CPA) are not conducive to achievement of transparent, balanced decisions on access pricing issues.

The existing patchwork of overlapping and inconsistent statements relating to pricing issues fails in a key objective of access pricing regulation – the encouragement of private negotiations on access pricing. Private parties at present face a number of unclear and inconsistent signals from the variety of principles set out in legislative and regulatory instruments. A clear, consistent set of principles on access pricing could serve to promote the efficient resolution of access pricing disputes by commercial parties, significantly improving overall economic efficiency in the infrastructure sector.

Part IIIA declaration criteria

The AGA supports the Commission's finding that Part IIIA declaration criteria must be reviewed to capture the fundamental objective of competition, that is, promoting economic efficiency. Declaration, or coverage in the case of the Code, of significant infrastructure assets should only occur where market failure has been demonstrated and where efficiency would be promoted by the decision.

The AGA therefore supports the proposed amendment of s 44G(2) (a) and (b) of the TPA to ensure that declaration of infrastructure assets only occurs where it would lead to a *substantial* increase in competition and that it would be uneconomic for anyone to provide a second facility.

This amendment to the current declaration criteria is consistent with the principle that access regulation should seek to identify clearly the objective and outcome being sought, not define the means by which it will be achieved. Declaration criteria and access regulation must seek the outcome of efficient competition, not simply the implementation of competition regardless of the risk of economically sub-optimal outcomes, a risk which is significant in the context of infrastructure services.

Declaration criteria should target static, allocative and dynamic efficiencies that flow from competition, not competition at a trivial level where efficiency may actually be reduced. The AGA welcomes the Commission's recognition that promoting the interests of potential access seekers *per se* is not what was intended by the existing 'promotion of competition' test.[3] The AGA considers that the outcome of the recent *Eastern Gas Pipeline* (EGP) appeal demonstrates that the decision to impose regulated access should be considered extremely carefully. Regulated access should not be imposed where there exists the potential for actual competition from other infrastructure services, or substitutable services in the case of energy, to promote economically efficient outcomes without regulatory intervention.

[3] Productivity Commission (2001), p.131

Information provision by the provider of a declared service

Informational asymmetries in the context of private negotiation for access to a natural monopoly asset have the potential to adversely affect overall efficiencies. Where feasible, steps should be taken to overcome these asymmetries. Effective commercial negotiations are more likely to achieve efficient outcomes if cost-effective means of overcoming informational asymmetries are in place.

In the case of gas distribution networks, information disclosure requirements in relation to access issues have been overly intrusive, time-consuming, and inflexible. Under Attachment A of the Code regulated gas businesses are required to submit to information requirements across six different categories and 33 sub-headings, covering such issues as property taxes and wage allocations by pricing zone, service provided or category of asset. The Code also contains further information requirements, requiring, for example, gas distribution network operators to provide queuing and spare capacity policies for potential users, even though these requirements are irrelevant to the operation of gas distribution networks.

Two principles should govern information provision in third party access regimes. The first is that information collection should be confined to matters relevant to the purpose for which the information is required. Information requirements should not be open-ended, and information should only be used for the purpose for which it was collected. The second principle is that maintenance of the confidentiality of information provided by commercial entities is the key to a process of information provision operating effectively.

Modification of the negotiate-arbitrate arrangements

Limiting arbitration to matters in dispute

Given the objective of an access regime is to promote economic efficiency by replicating efficient market outcomes there is little justification for regulators to intervene in matters not in dispute between parties seeking to negotiate for the provision of access.

As the Commission's Position Paper notes, enabling a regulator to reconsider matters not in dispute between informed commercial entities creates the risks of 'micro-management' of regulated businesses and the inefficient use of scarce regulatory resources.[4]

The role of the regulator in negotiate-arbitrate arrangements should be purely that of an independent arbiter. Substituting the decision of the regulator for that of the parties in matters not being contested takes the Australian Competition and Consumer Commission (ACCC) beyond the role that it should play, and which it is necessary for it to play.

[4] Productivity Commission (2001), p.163

For these reasons the AGA supports the Commission's Proposal 6.6, limiting the involvement of the ACCC in declaration decisions to those issues in dispute, unless compelling reason can be shown for why an alternative approach should be taken.

Part IIIA undertakings

Allowing lodgment of post-declaration undertakings

Arbitration represents a last resort option in the context of national access regimes. It is in some respects a necessary and logical adjunct to the declaration powers that the ACCC carries out under Part IIIA. Efficient access regulation is not well-served by repeated ad hoc arbitration. Partly in recognition of this industry-specific regimes have been developed, for example, in telecommunications, electricity and gas.

In this context, AGA considers that enabling infrastructure service providers with declared assets to lodge access undertakings would represent a positive development in access regulation. Access undertakings under Part IIIA are a far more flexible instrument than once and for all arbitrations made on an *ad hoc* basis. Access undertakings are also more likely to satisfy the requirements of investors in significant infrastructure assets relating to minimising regulatory risk. An access undertaking that sets out a framework for terms and conditions of access over a significant time period is also more likely to enhance downstream investment through increased certainty, and assist potential access seekers.

The proposals raised by the ACCC to allow a regulator to force the lodging of an access undertaking by, or impose an undertaking determined by the regulator on, an infrastructure service provider raises many significant policy issues. The proposals would fundamentally alter the basis of access undertakings under Part IIIA, transforming access undertakings into a regulatory instrument of control rather than a voluntary agreement between an infrastructure service provider and regulator. The AGA considers that this change would be unworkable and undesirable, and promote incentives for resource intensive gaming by infrastructure service providers and regulators.

Access pricing principles

The AGA welcomes the development by the Commission of a set of draft access pricing principles for inclusion in Part IIIA. The Commission's suggested pricing principles state that access prices should, *inter alia*:

- Generate revenue across regulated services sufficient to meet efficient long run costs of providing access, including a return on investment commensurate with risk;

- Not be so far above costs as to discourage the efficient use of the service and investment in related markets;

- Encourage multi-part tariffs and allow price discrimination when it aids efficiency; and

- Not allow discriminatory pricing from vertically integrated access providers in favour of associated downstream players, unless the cost of providing access to other parties is higher.

The AGA supports the broad scope of these access pricing principles, particular as they make explicit the requirement for sufficient revenue to be generated to allow the recovery of the efficient long-run cost of supply and a commensurate return on investment.

The AGA also supports the development and inclusion of a number of additional pricing principles. These pricing principles should include:

- Access prices determined by regulators should be consistent with the principle of financial capital maintenance;

- Access prices should incorporate a component to explicitly compensate for the impact of regulatory risk;

- Access prices should fully reflect service obligations and community expectations regarding service levels;

- Regulators should be required to include strong incentives to achieve productivity improvements; and

- Regulators should be required to ensure a fair sharing of gains from productivity improvements and technological change.

From principles to practice

Implementing clearer access pricing principles which are developed for Part IIIA within industry-specific regimes such as the Code will be challenging, but is essential for ensuring adequate ongoing investment in the gas pipeline and distribution network sectors.

Clearer access pricing principles could make a significant contribution to reducing uncertainty arising from regulatory discretion. One of the key elements of uncertainty for gas distribution networks relates to the Code requirement for regulators to forecast the efficient costs of the regulated service provider. The accurate forward estimation of an efficient level of costs for a five-year period is an unreasonable requirement of any regulator. Even if the task is completed with any degree of accuracy, the uncertainty regarding the final costs estimates which will be decided by a regulator, including the cost of capital, represents a significant deterrent to investment.

One of the key needs is for access regulation to focus on providing real incentives for infrastructure owners to achieve efficiencies and innovation. The Third Party Access

Code and its application by some regulators, however, has limited the incentives for efficiencies and innovation. In particular, the Code's requirement that review mechanisms be considered by regulators in cases where it is proposed that the regulatory period exceed five years has acted to generally restrict regulatory periods to five years, except in the case of the Central West Pipeline.[5] Shorter regulatory periods, particularly in the case of gas infrastructure, restrict incentives for operators to achieve efficiencies and innovation, and impose another element of regulatory uncertainty.

The forward looking cost-based 'building blocks' approach to access regulation that applies under the Code also dilutes incentives for the achievement of financial and technical efficiencies. Regulators operating under the Code acknowledge that:

> The history of cost plus regulation is replete with examples of heavily regulated utilities that exhibit low levels of efficiency, poor investment practices and below average service performance. Both theory and experience indicate that repeated frequent confiscation of the benefits of efficiency improvements combined with uncertainty over future regulatory actions will lead to poor performance and welfare loss.[6]

As the Commission notes, given this background, regulators should be seeking to improve on unregulated outcomes in a narrow range of specific circumstances, and recognise that precision is not available with the information and instruments available.

Consideration needs to be given to how access pricing principles can best encourage economic and technical efficiencies. Regulator's application of the Code has led to the effective pursuit of productive efficiencies. This pursuit has been to some degree at the expense of the adequate encouragement of dynamic efficiencies such as innovation and investment. Yet as the Australian Competition Tribunal has noted in the *Eastern Gas Pipeline* case, the encouragement of dynamic efficiencies is arguably a more important elements of competition than the promotion of production at least cost.[7]

Future Part IIIA decision making and administrative arrangements

Ending the role of Ministers in declaring and certifying services

The AGA considers that Ministerial involvement in declaration and certification decisions should be retained in its current form.

It is appropriate that key aspects of the administration of a national access regime remain the responsibility of Ministers. The AGA considers that Ministerial involvement in key regulatory processes is more likely to result in adequate consideration of complex national and public interest issues, transparency in process,

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[5] Section 3.18 *National Third Party Access Code for Natural Gas Pipeline Systems*
[6] Independent Pricing and Regulatory Tribunal, Position Paper, 1999, p.13
[7] Australian Competition Tribunal: *Duke Eastern Gas Pipeline Pty Ltd* [2001] AcompT 2, 63

and accountability in outcome, than a regulatory framework which does not allow for direct Ministerial action.

Ending the role of Ministers and developing a closed national access framework would be a retrograde step. Regulators do not have the resources, levels of accountability, or legislative mandate to be arbiters of national and public interest matters. Their role is narrower, to regulate infrastructure with natural monopoly characteristics in such a way as to balance the short and long term interests of users. Whether an asset is nationally significant, and whether it should be subject to access regulation or remain unregulated is a different class of decision than the determination of specific terms and conditions of access. The AGA is also concerned at the aggregation of power which would result from, in effect, allowing a regulator to be the first and last arbiter of key decisions relating to the provision of access.

Central to proposals to remove Ministerial involvement in key decision-making under Part IIIA is a concern that such involvement creates unnecessary delays and leads to regulatory uncertainty for access seekers and service providers. The AGA would contend, however, that if this is the rationale for suggested changes to Ministerial involvement in decision making, then alternative means should be considered. If reducing time delays and consequent uncertainty is the objective, the means should address that objective directly. One way in which this could be achieved is through the imposition of reasonable time limits on each part of the regulatory decision making process.

The AGA's experience with the Code does not support the argument that ending Ministerial involvement in regulatory processes is sufficient to overcome the issue of delays and uncertainty. The average length of time taken by regulators to approve Access Arrangements, involving no Ministerial consideration, under the Code is in the order of 20 months.[8] The AGA is skeptical of the proposition that downgrading the role of Ministerial oversight in key regulatory processes will improve incentives for timely regulatory decision making. Rather, the AGA considers that the issue of delays must be addressed more broadly through ensuring access regimes are efficient, cost-effective, and that regulators have adequate resources to deal with tasks delegated to them by government.

Similarly, if regulatory participants have concerns regarding the quality or availability of reasons for decisions these should be addressed directly, rather than through the alteration of the regulatory framework itself and elimination of Ministerial involvement in Part IIIA decisions. An obligation for decision-makers to provide reasons for a decision is one such direct means of achieving the stated policy objective.

[8] AGA *Gas Statistics Australia 2000*, p.48

Part IIIA appeals arrangements

Provision for full merit review of decisions on undertaking applications

The AGA supports the principle of full merit review being made consistently available across certifications, declarations, undertakings *and* decisions made by regulators under industry-specific regimes such as the Code.

The AGA supports the availability of full merit review in all third party access regimes. Matters being decided by regulators are significant and have a significant impact on investors as well as access seekers. It is general Australian practice that judicial decisions may be reviewed on a wide range of matters. Similarly, for many types of administrative decisions, review is available at least on their merits and often on other matters as well. It is therefore appropriate that regulatory decisions can be reviewed on their merits as well as other matters. The AGA also notes that significant decisions by the ACCC under the Trade Practices Act are subject to review, and that the Competition Principles Agreement provides for review of the decisions of tariff setting bodies. Finally, there is always the possibility that inappropriate regulatory decisions will be made, and these should be capable of correction through review. This is illustrated by the successful appeal of the decision on coverage of the Eastern Gas Pipeline.

Any concerns regarding the timeliness of decision making which arise from the proposal to allow reviews on undertaking decisions should be addressed through tighter rules on decision making not through retaining restrictions on access to merits reviews. Providing adequate review mechanisms in regulatory frameworks is critical to their success. The possibility of appeal of a regulator's decision is a key element in ensuring the reasonableness of regulatory decisions.

Transparency requirements

Requirement for statement of reasons for decisions by regulators on declaration, certification and undertaking applications

The AGA considers that the principle of decision-makers being required to provide adequate reasons for decisions should be a feature of regulatory and review processes under Part IIIA.

In particular, the AGA notes the regulatory uncertainty caused by decisions reached for reasons that are not clearly defined. This regulatory uncertainty decreases the ability of determinations to act as precedents and predictors of future regulatory behaviour, reducing the efficiency and effectiveness of third party access frameworks.

An example of the failure of Part IIIA to provide for sufficient reasons for decisions on nationally significant infrastructure is shown in the series of decisions relating to the coverage of the Eastern Gas Pipeline under the Third Party Access Code. In the National Competition Council's Draft Recommendation on Code coverage, the Council had concluded that it was difficult to determine whether coverage of the pipeline would promote competition, and set out two alternative options for

proceeding. As the Australian Competition Tribunal noted in its decision to uphold an appeal against the decision of the Minister to follow the Council's recommendation:

> By the time of its Final Recommendation, NCC had come to the conclusion that all four criteria in s 1.9 of the Code were met in respect of the whole of the EGP, but NCC did not expressly state the reasons which caused it to select the second of the alternative possible approaches in relation to criterion (a) identified in the draft, in preference to the first.[9]

In this case, the difference between the initial and final conclusions of the NCC was that the Council ultimately decided to recommend the regulation of a nationally significant infrastructure asset, rather than presuming that competitive pressures would result in an efficient outcome from both a market and social perspective.

Requirement for ACCC to publish post-arbitration reports

The AGA considers that a requirement for the ACCC to publish a post-arbitration report creates a significant risk of participants in arbitration being reluctant to provide adequate information for initial arbitration. This could occur because of the knowledge that information provided, with the potential to impact on future access negotiations, may be disclosed at a future stage. This would in turn tend to result in a reduction in the efficiency and effectiveness of regulatory outcomes.

The Commission has noted that price discrimination can be a feature of efficient assigning of a scarce resource, not as evidence of market power *per se*. Hence, caution would need to be applied in how post-arbitration reports were used by subsequent access seekers.

Making single body responsible for administering Part IIIA

The AGA considers the current arrangements for administering Part IIIA should be retained until there are compelling reasons to consider alternatives.

In considering the adoption of a single national regulator to administer all aspects of a revised Part IIIA, the Commission found it difficult to find conclusive evidence that the costs of such a move would outweigh the benefits. It is important to ensure that consistent rules and processes are in place that promote adequate ongoing investment in infrastructure across access regimes under Part IIIA. The administration of those rules is a second-order issue.

The AGA does not believe that the benefits of a move to a single body administering Part IIIA have been convincingly demonstrated. Given the concentration of decision making power in the proposed model, where the same body could determine whether a gas transmission pipeline was to be declared, and also set the terms and conditions for access seekers, more evidence is needed of the inadequacies of the present approach.

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[9] Australian Competition Tribunal: *Duke Eastern Gas Pipeline Pty Ltd* [2001] AcompT 2, 44

Responses to Requests for Further Information

Costs of industry-specific regimes

The high cost of regulatory compliance is a core concern of AGA members who operate gas pipelines and distribution networks under the Code.

As the Position Paper identifies, regulation that does not cost-effectively achieve its objectives erodes consumer benefit. While there is some discussion in the Position Paper on the costs of industry-specific access regimes, there is no reference to the costs of maintaining regulators which oversee the implementation of the Code. Gas distribution network operators and pipeliners have consistently found the Code to be heavy-handed and extremely information-intensive. The costs of providing regulatory oversight for access regimes make up at least nominally another half of the total cost of third party access regulation. The AGA would value analysis being conducted which took this into account and assessed the true 'whole of economy' cost of regulation.

The cost to regulated gas businesses of the Code has been substantial. An inappropriate extension of coverage of the Code has further accentuated the imbalance between the costs and benefits of third party access regulation created by the Code.

Information Box 1: The Cost of Regulation under the Code

One example of the unnecessarily high cost of regulation under the Code was the requirement that was placed on Envestra Ltd to submit an Access Arrangement for the Palm Valley to Alice Springs transmission pipeline. This small 164 kilometre pipeline has around 7 per cent of the gas carrying capacity of the Moomba to Sydney pipeline. The Code coverage of this relatively minor transmission asset imposed extremely high costs on end-users. The substantial cost of submitting an Access Arrangement for this pipeline represented around 15 per cent of the final tariffs to users, a perverse cost outcome for a regime seeking to benefit service providers and final consumers.

Coverage of this pipeline has now been revoked, however the revocation procedure under the Code is complex and has imposed further regulatory costs.

The AGA estimates that since the introduction of the Code, the cost to operators of gas transmission pipelines of preparing Access Arrangements for approval by regulators has been over $13 million. This substantial figure, which excludes the numerous Access Arrangements that have been required to be prepared by operators of gas distribution networks, raises serious doubts as to the cost-effectiveness of the Code as it is currently applied and interpreted.

The cost of the complying with the Code has been increased substantially by inconsistencies in interpretation of the Code by regulators in different jurisdictions. As an example, a gas distribution business with networks in multiple jurisdictions

recently submitted draft Access Arrangements to review processes being coordinated by regulatory authorities in Queensland and South Australia. Despite providing an identical format for the non-network specific components of the Access Arrangements, each regulatory jurisdiction has separately approached the regulated business, requiring inconsistent alterations to the structure of the Access Arrangement. Thus, despite the existence of such bodies as the Utility Regulators Forum, nationally consistent regulatory requirements on gas distribution businesses operating in multiple jurisdictions are yet to be achieved. The same gas distribution network business will soon be submitting a draft Access Arrangement to Victorian regulatory authorities, and, on past experience, it would seem further wasteful inconsistencies in requirements and methodologies are likely to be revealed. This inconsistency adds significantly to the cost of regulation under the Code, as it prevents gas network businesses taking full advantage of economies of scope and scale in responding to multiple regulatory authorities.

Additional costs of regulation under the Code relate to the deterrent to investment associated with uncertainty arising out of regulatory discretion. This uncertainty, and the current Code, arguably distracts regulated gas businesses from pursuing more productive core activities, imposing a further opportunity cost on the community.

Impact of access regulation on investment

The impact of access regulation on investment in infrastructure is a key regulatory issue, and the AGA welcomes the Productivity Commission's examination of the area.

A key disincentive for proponents of new investments in gas pipelines and distribution networks is that under current access regulation investors in new infrastructure projects face the prospect of a maximum capped return. This maximum return can be derived in the case of gas pipelines and distribution networks from the likely return from reference tariffs for third party access. The project proponent, however, assumes all of the downside risks associated with potential changes in market conditions, project financing etc.

Proponents face an additional regulatory risk that any efficiently constructed spare capacity will be accessed at prices inadequate to give a long-run return on the asset. A further risk is that a regulator will determine in retrospect and using information unavailable to the proponent at the time of the project go-ahead, that the investment was not prudent. These factors result in a dilemma for the prospective investor in infrastructure assets. While their investment is subject to market, operational, regulatory risks that may conceivably be able to compensated for by above forecast returns, under the Code revenues above those forecast are captured by regulators and shared by subsequent access seekers.

Regulators have responded to this dilemma by claiming to have granted rates of return on infrastructure investment which recognise the specific risk profiles of gas infrastructure. The ACCC, for example, claims that the 15.4 per cent return granted to the Central West Pipeline represents a favourable return as compared to the average returns of a diversified portfolio of equities on the Australian stock exchange. This

comparison, however, gives an incomplete understanding of the choices facing potential investors in gas infrastructure. The construction, operational, financial, environmental, geographical and regulatory risks assumed by an infrastructure investor are non-diversifiable. That is, they are narrow in scope and a limited capacity exists to hedge against these risks. Further, a potential investor in significant gas infrastructure cannot make their investment liquid in a short time with minimal transaction costs, a choice open to an investor in a broad portfolio of listed stocks. Finally, investors in a broad portfolio of stocks can benefit from the upside and as well as the downside risks. These differences make a meaningful comparison between equity returns and individual project investment returns difficult.

There is a growing recognition that in the area of gas distribution networks and pipelines the impact of a restrictive application of access regulation on investment has been negative. One example is the delay caused by the difficulty the proponents of the Central Ranges Pipeline (from Dubbo to Tamworth) have experienced in resolving issues about achieving an adequate return commensurate with the specific risks that the pipeline faces when combined with uncertainty about the impact of access regulation. In the light of likely levels of return that may be allowed by regulators the project is delayed as proponents examine ways to reduce market risk.

The Office of the Regulator-General (ORG) in Victoria has acknowledged some of the particular regulatory risks that face proponents of extensions of gas distribution networks. In particular, in its *Final Decision on Application for Revision to Westar's (TXU) Gas Access Arrangement* relating to a proposed extension of gas infrastructure to Barwon Heads in February 2001, the ORG commented:

> ...certain aspects of the current regulatory arrangements appear to have created an obstacle to the extension of gas distribution networks to certain regional towns and cities which would be economically viable to supply in other respects.[10]

In February 2001, the ORG announced an interim policy and future regulatory arrangements for network extensions in recognition of the particular issues facing investment in this area, however, TXU Networks do not at present consider these arrangements sufficiently address their concerns.

Project delays or cancellations inevitably involve considerable losses in dynamic efficiencies. In the case of the proposed Barwon Heads extension, residents have been prevented from enjoying an estimated $1000 per annum in energy cost savings, presumably because of a regulatory presumption that in the pricing structures underpinning marginal network extensions, a potential risk exists of the extraction of monopoly rent. Due to the current interpretation of the Code, therefore, an investment will not proceed and consumers in regional Victoria will not be offered a new competitive fuel source.

The AGA considers that in relation to the expansion of gas distribution networks or pipelines to new regional areas, the underlying rationale for regulated third party

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[10] Office of the Regulator-General *Final Decision on Application for Revision to Westar's (TXU) Gas Access Arrangement*, February 2001, p.2

access, the presumption that the infrastructure possesses natural monopoly characteristics, is questionable. In particular, as the Australian Competition Tribunal has noted in relation to regional gas markets in the *Eastern Gas Pipeline* decision:

> ...as gas has not previously been available...the prices of existing forms of energy will be a countervailing force on the price of gas and pipeline services...In the regional markets, other forms of energy warrant consideration because gas is being offered as an alternative to existing forms of energy.[11]

These comments highlight the need for third party access regimes and regulatory determinations that take into consideration and interact appropriately with energy market conditions.

Contestability of greenfields projects

Greenfields infrastructure projects such as network expansions or new pipelines are most likely to be undertaken when they are judged to be sufficiently profitable, commensurate with the risk, by investors. That is, a project will be likely to proceed when market and other risks balanced against possible returns from the project will lead to an adequate return on capital committed to the project.

This results in network expansions and new pipelines being, in effect, contestable at the construction phase. Prospective service providers undertake ongoing analysis and forecasting of the likely profitability and possibility of obtaining a commercial rate of return on a range of available projects. When a potential market opportunity develops to the position where a project is likely to be sufficiently profitable, it is likely to be undertaken. Moreover, since the cost structures of project proponents may be broadly comparable, there will tend to be a number of potential projects relating to the same market sponsored by different sets of investors. Indeed, in a competitive market with limited investment opportunities, commercial positioning may lead to a company investing in the project just before it is marginally profitable, in order to take advantage of economies of scope or scale.

These factors mean that most network expansion or new pipeline projects can be argued to be contestable at the construction phase. That is, it will be unlikely that given the competitive process for determining the new service provider, that the prices to end-users will contain any element of monopoly rent. In these circumstances, it is arguable that a regulated third party access regime on the new infrastructure is inappropriate.

Merits of price-monitoring as alternative to declaration

The AGA supports further exploration of the potential benefits of forms of price monitoring as opposed to a cost-based 'building-block' approach generally taken in relation to the regulation of gas network and pipeline assets.

[11] Australian Competition Tribunal: *Duke Eastern Gas Pipeline Pty Ltd* [2001] AcompT 2, 129

Price monitoring may represent a more appropriate regulatory framework for the gas network and pipeline sectors, as it would recognise the existence of a wider energy market, within which gas competes for market share. Gas is a fuel of choice, whereas electricity is an essential service. A high degree of substitutability exists. As such, gas will expand its market share where it can demonstrate benefits to customers from fuel switching for a specific range of industrial, manufacturing, power generation or household applications. In this competitive market environment, it is questionable whether at the end-user level gas can accurately be characterised as a natural monopoly service.

Price monitoring has been suggested as one possible response to the issue of competing pipelines. Where pipelines service the same broadly defined market, price monitoring could be more efficient and cost-effective than the current form of regulatory oversight. Given the decision of the Australian Competition Tribunal in the *Eastern Gas Pipeline* case, however, the AGA considers that where there is prospect of actual competition without regulatory intervention, this competition should as a matter of policy be encouraged in preference to potentially costly regulatory oversight.

In some circumstances, the concept of price monitoring could be valuable as a 'half-way house' between full regulation of certain assets under Part IIIA or industry-specific arrangements such as the Code, and an absence of any regulatory oversight. This mechanism could apply in cases where it was not possible to clearly determine whether the costs of regulation of an asset would outweigh possible benefits arising from the promotion of competition. This mechanism could be justified as a practical implementation of a principle recognised by the Australian Competition Tribunal in *Re: Review of Freight Handling Services at Sydney International Airport* (2000). This principle is that regulatory controls designed to mimic the operation of a free marketplace are 'second best' to the outcomes produced by actual competition.

Sufficiency of information

The AGA recognises that providing sufficient information is essential to and can help facilitate improved private negotiations and regulatory outcomes.

Some regulated gas businesses, however, have found that some regulators tend to approach information requirements in an untargeted way that results in a high cost to both the regulated business and the final consumer.

Requirements for the provision of information should take account of the relevance of information and ensure the appropriate confidentiality of sensitive information provided. In the case of declaration, information should be relevant for and confidential to negotiation purposes. In the case of the Code information should be relevant to what regulators require, what should appropriately be made public, and should be kept confidential unless it is appropriate for it to be otherwise.

Information Box 2: IPART Regulatory Compliance Officers

In September 2000, the New South Wales Independent Pricing and Regulatory Tribunal (IPART) proposed the mandatory employment of regulatory compliance officers by electricity distributors.[12] These regulatory compliance officers were to be employed by individual electricity distributors but responsible to IPART. The proposed function of the compliance officer in the regulated business was to monitor compliance in relation to ring-fencing obligations imposed by the regulator and to report potential breaches of these obligations to IPART.

The proposal effectively envisaged the establishment of two tiers of employee, one responsible to the regulated business, and one responsible to the regulator. After being raised in an IPART discussion paper, this novel outsourcing of regulatory responsibilities and costs has not been pursued.

There must also be recognition that information disclosure requirements may also create the risk of anti-competitive outcomes by promoting parallel pricing. While Code provisions relating to information disclosure provide a vehicle for users to protect their interests, they also enable competing operators to know the intentions of competitors with respect to future capital expenditure and expected sales volumes. Requirements to provide this kind of commercially sensitive data has the potential to encourage anti-competitive pricing, and caution should be exercised in proposals for widening such requirements.

Final offer arbitration

Although interesting as a regulatory decision-making tool, the AGA considers final offer arbitration to be inappropriate at this time for application to access regimes.

Final-offer arbitration, while containing useful incentives to discourage ambit claims from regulators and regulated entities, is inappropriate for the current regulatory environment in which there is at least an attempt to work towards a verifiable, objective analysis of a balanced regulatory outcome. The aim of access regulation should be to have efficient access prices. In contrast, final offer arbitration could lead to inappropriate access pricing determinations that affect efficiency over the long term, with significant potential for the distortion of downstream markets.

The AGA would prefer that focus remained on achieving access pricing principles that encourage adequate ongoing investment in gas infrastructure and improved regulatory outcomes.

[12] Independent Pricing and Regulatory Tribunal, *Draft Ring Fencing Guidelines for NSW Electricity Distributors*, September 2000, p.25

Modifying who may lodge an Access Undertaking

Access undertakings are a useful regulatory mechanism with the potential to promote regulatory certainty and ongoing investment in gas infrastructure.

The ability for a prospective service provider to have an agreed set of terms and conditions relating to third party access before the commencement of a project facilitates greater certainty and investment in infrastructure projects.

For this reason, the AGA does not support any proposals that would fundamentally alter the status of access undertakings. The proposal to allow State and Territory jurisdictions to submit access undertaking over prospective infrastructure would have this effect. The AGA does not consider an adequate case has been made to alter the basis of access undertakings in this way.

Jurisdiction sponsored access undertakings would alter the voluntary and cooperative basis of this important regulatory route. They would have the effective of binding third parties with little or no opportunity for those parties to make representations to the regulator on the merits of the established terms and conditions of access. Prospective investors in gas infrastructure would, in effect, be put in the position of 'taking or leaving' access terms and conditions negotiated between a regulator, and a State or Territory government. Neither of these parties to negotiations on terms and conditions of access would be driven by commercial pressures or informed by direct experience of the commercial drivers that underpin significant investment decisions, leading to the significant risk of inappropriate final outcomes.

The AGA believes that while there may be some parallels in the certification and undertaking processes, jurisdictions should be required to apply for certification for non-project specific access regimes. While the certification process has been frustratingly slow in several key areas, this issue should be addressed by direct means, such as the more explicit linking of competition payments to outcomes, or the imposition of credible time-limits on regulatory processes. A proposed solution to delays that is based on jurisdictions having less incentive to develop objective, nationally consistent and generic access regimes is arguably a case of the cure being worse than the disease.

Access holidays

Access holidays represent a potentially valuable regulatory tool to address the specific issues facing new infrastructure or infrastructure expansions. The concept of access holidays is one that should be considered as a matter of priority.

Access holidays address two key issues faced by proponents of new infrastructure in regulated environments. The first is that while access regulation effectively caps the profitability of a particular project, access regulation does not mitigate against losses if the project is unsuccessful. This alters the usual decision making framework faced by investors in significant projects, because the investor effectively assumes all of the downside risk while having the prospect of extracting higher returns to compensate for risk limited. The second issue is the regulatory risk represented by periodic

reviews. By offering a measure of protection against regulatory intervention and regulatory resets for a set period that more closely aligns with the actual investment horizon of gas infrastructure assets, access holidays may reduce regulatory uncertainty.

One key operational issue that would require careful consideration is eligibility. Clearly from a policy perspective, there are strong arguments for excluding projects of demonstrable profitability, which do not face unacceptable regulatory uncertainty. As previously discussed, however, there is an equally compelling argument that in a competitive market for infrastructure projects, it is unlikely that there are undeveloped projects which would result in certain, high or supra-normal profits if developed immediately. This being the case, an access holiday might operate on the basis that new projects are assumed to be marginal, unless a verification undertaken by a body independent of both the project proponent and final regulator demonstrated otherwise. Alternatively, a set of criteria could be developed to have a similar effect.

The AGA would contend that expansions of existing infrastructure networks should be eligible under any system of access holidays which is developed. Despite any perceived difficulties with implementing this feature, the AGA considers there are strong public policy grounds for developing rules that include projects such as expansions or extensions of gas networks that have greenfields characteristics. These characteristics include uncertain or marginal returns on a 'whole of project life' calculation, significant market and regulatory risks, and the potential to benefit a large number of new users. In this regard, the most significant benefits that gas networks can provide to regional centres are energy choice and cost-savings. As the Commission correctly notes:

> Notwithstanding the possible short term efficiency losses from lower than optimal use of the service concerned, at the end of the day, if infrastructure facilities are not built, consumers will be worse off.[13]

In May 2001, the AGA released a Research Paper that examined the benefits that flow from new and expanded gas infrastructure in regional Australia. Some of the key findings of this paper regarding the benefits of new gas infrastructure for regional Australia are outlined in the Information Box below. The encouragement of a regulatory environment that promotes ongoing investment in gas infrastructure must flow from the recognition that multiple parties can be disadvantaged by a decision not to invest. Examples of these parties include regional towns, associated manufacturing, minerals processing, and customers missing out on the benefits of energy choice and inter-fuel competition.

The delaying of the Central Ranges Pipeline is an example of greenfields infrastructure with significant regional benefits that may have been significantly assisted by the provision of an access holiday. The AGA argues that there is sufficient evidence of a lack of regulatory certainty leading to the delay or canceling of the expansion of gas infrastructure to warrant further consideration of the possible implementation of access holidays.

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[13] Productivity Commission (2001), p.193

Information Box 3: Benefits of Gas Infrastructure to Regional Australia

Substantial energy cost savings and other benefits flow from the development of new transmission pipelines and extensions of gas distribution networks. These benefits include:

- Access to a new low cost energy source for existing domestic, commercial and industrial users
- Attraction of new industries to regions through the availability of low cost energy, and increased competitiveness for existing industries
- Increased price stability through access to long term energy contracts
- Reduction in oil, coal and LPG prices as a result of increased competition from natural gas

Specific examples of the cost savings to individual businesses flowing from the expansion of gas transmission pipelines into regional Australia include a vegetable processing plant in Bairnsdale achieving a 30-55 per cent energy cost reduction, and food processing facilities reducing annual energy costs by $70 000-100 000. The development of a pipeline from Dubbo to Tamworth is estimated to have the potential to lead to energy cost savings for industrial and commercial users of 35-40 per cent. The existing pipeline from Marsden to Dubbo is estimated to have lead to energy cost savings to commercial and industrial users of up to 40 per cent.[14]

The implementation of the concept of access holidays would require the resolution of several key issues. For example, consideration would need to be given to when access holidays would begin and end, as well as to whether the length of the access holiday would vary according to infrastructure type. There may be scope, for example, for an access holiday to become effective after the post-construction period of initial capital losses (which can in some circumstances be written down via tax or other means). Thus an access holiday could instead begin in the period in which profits that compensate the investor for the risks in the project are made (typically, well into the life of the asset). This would address the disincentive facing project proponents that higher than normal profits in out years required to compensate for the marginal nature or specific risk profile of the project may be eroded by the terms of third party access. This disincentive is arguably more significant in the context of gas pipelines and network expansions than the early losses associated with investment in a marginal long-lived project.

That access holidays need to be considered as a tool to reduce regulatory risk and encourage ongoing investment in infrastructure services points to several significant failings in the current national access regime. It illustrates dramatically the need to ensure appropriate declaration and coverage criteria, and access pricing principles, are

[14] AGA Research Paper No 14: *Gas Transmission Pipelines: Energy Cost Savings for Regional Centres*, May 2001

in place for third party access regimes. In addition, it points to the need to further examine practical options for encouraging infrastructure development, such as regulatory safe harbours, or regulatory compacts in which key financial parameters such as the regulated cost of capital is guaranteed for the economic life of a greenfields project.

Valuing infrastructure assets

The AGA views the methodologies used for asset valuations as of critical importance given that a regulatory capital base is a key determinant of the overall return on equity of regulated businesses.

Gas infrastructure is inherently capital-intensive, with up to 70 per cent of revenue capital based. It is inevitable that regulatory discretion plays a role in reaching an estimate of the depreciated optimised replacement cost (DORC) of regulated assets. The current 30 per cent variability in estimated and final assessed DORCs, however, represents an unacceptable level of regulatory risk.[15]

However, adopting a depreciated actual cost methodology with 'prudence reviews' creates the risk of merely substituting the regulatory energy consumed in arriving at DORC and judgements about prudent expenditure under such sections a 8.16 of the Code with another more general process potentially subject to similar levels of regulatory uncertainty.

Asset valuation is one of a number of areas in which regulators arguably have too much discretion that has been imprecisely exercised. As the Commission suggests this may be a reason to at least examine lighter handed versions of 'CPI-x' price regulation. It would be crucial, however for the 'x' to be a credible benchmark such as total factor productivity, which recognises the real conditions gas network operators face in Australia. Abstracted benchmarks from densely populated countries with substantially different geographic and climatic conditions such as the United Kingdom or the United States are mostly of limited use for Australian regulatory authorities.

One means of addressing the regulatory risk arising from discretion over valuations of capital assets is the inclusion in access pricing principles of a requirement of financial capital maintenance for projects determined not to be imprudent by regulators at the time of investment. This would have the positive effect of limiting regulatory risk as it related to the value of infrastructure projects deemed to be efficient at the time of project go-ahead.

Facilitating participation of consumer interests in Part IIIA

The funding of enhanced consumer input into the access pricing regulatory processes raises significant issues which need to be more carefully considered before any recommendations are developed by the Commission.

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[15] Productivity Commission (2001), p.221

The first issue is whether any enhancement is necessary, or would justify the greater costs it would impose on regulatory processes and the efficiency of any final outcome. The AGA considers that in the case of most infrastructure classes there is already a substantial compatibility of interests between access seekers and final users. That is, access seekers are likely to be motivated by a desire to lower the cost of access, and to derive market share from the undercutting of the margins of other commercial players on the end-use of the service. As access seekers, like service providers are profit-driven, they will have a direct interest in aggressively participating in regulatory processes to achieve the lowest possible access price. Given this, the input into the regulatory process from access seekers can be viewed as a proxy for that of the final user.

In addition, the AGA contends that the regulator in most instances is more than adequately motivated to achieve the lowest final user cost possible. In some cases, for example the Australian Competition and Consumer Commission, a consumer mandate is a fundamental and explicit part of a regulator's role. In others, regulators have given their decisions a strongly consumer flavour, publicly announcing price falls that result from regulatory determination in media releases. Indeed, given the absence of coherent guidance on the basis and objectives of access regulation (which will hopefully be addressed by the adoption of an appropriate and balanced objects clause and access pricing principles) regulators have understandably been exploring the nature of their role in relation to access regulation. This lack of guidance has been exacerbated by the reality of substantial pressures on regulators in two different directions. Firstly, falling final prices in the short term are incorrectly taken as de facto evidence of the success of regulatory process and secondly, infrastructure under-investment is usually less visible, and its damaging effects usually only become apparently over a longer time frame.

If enhancing consumer input into regulatory processes is to be further considered, the AGA would argue that the preferences of consumers in the supply of infrastructure services would need to be objectively established. Evidence from the UK water regulatory process, as well as the review of electricity distribution that has recently taken place in Victoria shows that security of supply and reliability are key consumer requirements. Indeed, consumers in both of these cases indicated that they were willing to pay more than they were currently paying to ensure their expectations regarding security and reliability were met.

This prioritisation of preferences makes clear one key difference between access seekers and consumers. Price and terms and conditions of access is the dominant concern of access seekers, whereas as indicated, consumers tend to take a perspective that values overall system reliability and security of supply more highly than individual profit-driven access seekers.

For these reasons the AGA considers it questionable that extracting a premium via taxes or the final price of infrastructure services to fund separate representation in the regulatory process for consumers would be of any practical benefit.

Implementation Issues

The AGA considers that many of the recommendation of the Commission's Position Paper have the potential to lead to substantial improvements in the effectiveness of regulatory outcomes. As a matter of policy, therefore, AGA considers that the Commission should strongly encourage governments to move to implement most of the Commission's Tier 1 reforms in a timely fashion.

The AGA is particularly concerned that the possible benefits of the Commission's proposed reforms to third party access regulation of gas pipelines and distribution networks are captured quickly. The AGA considers that given the Productivity Commission has determined some key principles regarding access regulation, subsequent reviews of access regulation in gas and electricity should use those principles as the basis of developing specific reform proposals to industry-specific access regimes.

This can best be achieved if the Productivity Commission is appointed to carry out the planned reviews of third party access regimes for gas and electricity. The timing of these reviews is an important opportunity to align industry-specific access regimes covering significant infrastructure assets with an enhanced national access regime arising from the Commission's review of Part IIIA.