ALLGAS ENERGY LTD

Submission to the Productivity Commission Draft Report

REVIEW OF THE GAS ACCESS REGIME

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EXECUTIVE SUMMARY

Allgas Energy Ltd (Allgas) appreciates the opportunity to comment on the Productivity Commission's Draft Report on reform of the gas access regime of 15 December 2003.

Allgas fully supports the Commission's intention to shift regulation to a more efficient, equitable and pro-competitive approach. As noted previously to the Commission, the replacement of poorly thought out and improperly applied regulation by good regulation which mimics real world competitive forces will unleash a latent dynamism in the energy sector.

Unfortunately, Allgas is of the view that the recommended solution contained in the Draft Report will not achieve the Commission's purpose. In particular, it is considered that key recommendations are unsustainable at law and raise natural justice concerns. The Terms of Reference for this review require the taking account of relevant court cases, including Australian Competition Tribunal (ACT) decisions. It is our view, with respect, that the Draft Report errs in not taking into account two decisions which fundamentally affect the recommendations. In addition, it would appear that the Final Report should also take into account two other decisions made shortly after the Draft was released.

Firstly, it is Allgas' contention that the Draft Report errs in not taking into account the Western Australian Supreme Court (WASC) judgement on the Epic case of August 2002 with respect to the type of competition that is to be mimicked and how economic efficiency is to be regarded under the Gas Code. This case was mentioned in the Terms of Reference and these two issues were fundamental to the Court's findings and are directly relevant to the proposed objects clause and two of the tests.

Allgas is also concerned that the Draft Report appears to have not taken account of the arguments on these matters by Professor David Round, (see Allgas submission November 2003) but only considers the ACCC's contrary views. As the ACCC's views are effectively demolished by Round in terms of both economic argument and the law, this appears to be a serious deficiency in the Draft Report. As Round notes (p1):

> *"The Australian Competition and Consumer Commission supports an approach based on a building blocks model that seeks to replicate the static efficiency outcomes of a perfectly competitive market. This type of approach was found to be unacceptable by the WASC, which argued strongly that regulation should aim to achieve outcomes consistent with those that would be found in a workably competitive market."*

Secondly, the Draft Report does not take into account the decisions by Federal Minister Ian Macfarlane MP on issues of competition, efficiency and the public interest on the application by East Australian Pipeline Ltd for revocation of coverage of the Moomba-Sydney Pipeline (MSP) system under the Code of 19 November 2003. In effect, the Ministerial Decision reflects the Epic case in rejecting the practice of regulators of replicating perfect competition. He also opposes the imposition of regulation without substantial evidence of abuse, emphasises the risks

of regulation leading to under-investment, and prefers - like Justice French in the Loy Yang case below - to assess competition on the basis of actual market behaviours.

It is understood that the Ministerial Decision was upheld on review by the Australian Competition Tribunal on 12 February 2004.

Two cases which followed the release of the Draft Report also have fundamental implications for the sustainability of the recommendations. These are:

- the Federal Court's judgement (Proceeding No. V880) on the action by AGL against the ACCC over the acquisition of the Loy Yang Power Station Business of 19 December 2003; and

- the Australian Competition Tribunal judgement in the GasNet appeal against the ACCC of 23 December 2003.

In Allgas' view, each of these cases is sufficient to undermine the sustainability of the Draft Report's recommendations. Taken together, they are a powerful force for change if increasing and widespread litigation is to be avoided. Indeed, it would appear to be beyond the powers of Government to accept the Commission's recommendations under the Hilmer reforms as the intent of the laws and the interpretation of concepts have now been established by legal processes. The recent decisions suggest that the following matters in the Draft Report are unsustainable at law:

- the first tier recommendation that gas companies have their tariffs regulated according to the current cost of service approach using a CAPM methodology

  - the recommended objects clause relating to what appears to be 'ideal' economic efficiency,
  - the new economic efficiency test;

- the 'matters to consider' in assessing the recommended competition test;

- that currently covered companies should start the new regime under the first tier; and

- the assumption that regulators may establish access arrangements and determine tariffs for companies subject to the first tier in contradiction to the proposals of those companies.

Nonetheless, our view is that these deficiencies in the recommendations are easily rectified by changing the direction of the approach and clarifying the meaning of the concepts involved under the law as expressed in the judgements on Epic, Moomba-Sydney, Loy Yang and GasNet.

The following changes are suggested to make the general approach of the Draft Report sustainable at law and in conformance with natural justice principles:

- clarify the concepts of competition and economic efficiency in accordance with the Epic and Moomba-Sydney decisions

  - ensuring that the CAPM (WACC) methodology as currently applied may not be used deterministically in constructing regulated tariffs under tier 1 unless proposed by the service provider, and

  - ensuring that outcomes in tier 1 conform with workably competitive outcomes;

- adjust the "matters to consider" in the competition test in accordance with the Loy Yang case, shifting the focus from structuralism to the behaviour of market participants;

- declare all currently covered pipelines and distribution networks under tier 2 (monitoring) for five years

  - this would provide sufficient time for them to establish whether or not they are capable of performing to the requirements of a workably competitive market under their own direction and in cooperation with customers;

- regulate those companies which fail to perform to those requirements to the first tier, where tariffs would be set by the regulator rather than monitored;

- under tier 1, companies may propose access arrangements and tariffs which conform with the objects clause

  - where such proposals fail to satisfy the objects clause, regulators may reject such proposals and set conditions which emulate workable competition;

  - where such conditions are objected to by the regulated company, an appeal may be lodged with the Australian Competition Tribunal; and

- under tier 1, where companies and their customers propose cost of service, regulated tariffs are set not only to reflect the risks and uncertainties of the methodology, but also to provide the level of service provision demanded by customers, in keeping with an objects clause that is interpreted in workably competitive terms.

Allgas believes that these proposals deserve consideration by the Commission for the following reasons.

First, they are in line with the decisions of the courts, the Federal Minister and the Australian Competition Tribunal in their interpretations of the intent and meaning of the Hilmer reforms, the Gas Code, and the concepts of competition and efficiency.

Secondly, emulating the process of inter-firm rivalry in all its forms will greatly benefit consumers and the community. There will be greater security and reliability of supply, choice of innovative new energy services and better environmental and social outcomes. These outcomes are not possible under cost of service, which focuses on never ending cost cutting, as witness the rejection of proposals by electricity distributors of such packages by several jurisdictional regulators.

Thirdly, as in the tariff debate, there is an optimal level of regulation. The problem regulatory reform should be addressing is not any actual abuse of market power but the development of the gas industry in line with the expectations of the Ministerial Council of Energy and CoAG. The current regulatory approach is inimicable to such development and is costly to administer.

The Commission's proposal for a two tier system is a good one. But the *a priori* assumption should be that regulated companies will produce welfare enhancing outcomes under tier 2. That is, "don't hang them until they hang themselves" by starting companies under tier 2 and relegating them to tier 1 if they fail to perform.

It also has to be recognised that even monitoring is not costless. Rather than any day-to-day involvement by regulators, the optimal approach would be similar to the formal monitoring provisions added in 1995 to the Prices Surveillance Act 1983, where performance reviews are conducted at the end of a regulatory period. In addition, the onus of proof in the proposed tests should be reversed.

Fourthly, regulated tariffs under tier 1 should also aim to induce workably competitive outcomes. This will require the deep involvement of the regulator. Unless firms in this tier make a real effort to achieve such outcomes, they should not expect a normal rate of return, as happens in a market.

Finally, a number of structural changes need to be made to the Gas Code to accommodate these suggestions. The recently formed Energy Networks Association (ENA) will be providing a submission with details of proposed amendments. But what is fundamentally needed is a change in the views of regulators. The prospects of this happening with generational and institutional change look bright. However, in the meantime, provision must be made for merits appeals with the Australian Competition Tribunal.

DEFICIENCY 1: FIRST TIER, COST OF SERVICE

The Commission's first tier recommendation relies on the current cost of service approach incorporating a CAPM methodology to produce a WACC that becomes the mechanism for determining a regulated rate of return. This is unsustainable as a basis for reform going forward for two legal reasons. One reason is that CAPM outcomes abrogate the original intention of the overarching regulatory legislation under the Hilmer reforms. Businesses condemned to the first tier would therefore be likely to (successfully) challenge such an arrangement in court or on appeal to the Australian Competition Tribunal.

As Professor Round notes in addressing the ACCC's approach to regulation in Allgas' November 2003 submission to the Commission:

> *"If in applying the Code the ACCC fails to adopt the WASC's view in the Epic decision, it leaves itself open to a formal challenge to its methods. Equally, as the Epic decision is currently the only decision by a superior court interpreting the concept of competition that underlies the Code, the ACCC's next consideration of an issue under the Code may result in a decision that fails to endorse the WASC's view. In doing so an outcome may result that does not maximise consumer welfare, but, given the time that has passed*

since the WASC's decision, the ACCC may consciously be ignoring the Epic decision and may have elected to continue to regulate under its traditional perfect competition model, until this approach is challenged."

It is Allgas' contention that this is an unsustainable situation going forward. While the ACCC may take the risk of acting beyond its powers until challenged, it is inappropriate for the Productivity Commission to recommend such a situation as a basis for the second phase of energy reform.

A description of what is the WASC's view and how this differs from what is currently applied under cost of service is provided in Allgas' two submissions to this review (August and November 2003) with contributions from Professors Littlechild and Round. All that argument is not repeated here except to say that the concepts of efficiency and competition in the Draft Report do not appear to correspond to the legal view. In essence, and as argued in detail in Allgas' submissions:

Competition

- The current regulatory approach (CAPM, WACC) replicates the static neoclassical concept of perfect competition (see references to Professors Beesley, Littlechild and Round).

- The Justices in WASC specifically excluded perfect competition as a basis for regulation under the law and specified that the Hilmer reforms (and the Gas Code) require the replication of workable competition.

- Going forward, the intention of the law should be clarified in the objects clause by prohibiting replication of perfectly competitive market equilibria by any means and specifying the replication of modern day interpretations of workable competition, as provided by the Justices,

  - For a description of workable competition, see the Allgas submissions and contributions from Professors Littlechild and Round. It will be noted that these analyses highlight fundamental errors in the ACCC's views on workable competition.

Economic Efficiency

- The Justices in WASC rejected the neoclassical 'ideal' notion of long run competitive equilibrium as the interpretation of economic efficiency under the law.

- Instead of this 'ideal', the Justices said that regulators should emulate the process of competition in workable competitive markets and that these outcomes (of the process itself) should be regarded as economically efficient under the law.

- Going forward, the intention of the law should be clarified by specifying workable competitive outcomes as achievement of economic efficiency, as provided by the Justices.

The Draft Report does not take into account the legal clarification of the concepts of competition and economic efficiency under the law. The legal interpretations of these

concepts will not change no matter how recommendations are framed in the Final Report, and it is unsustainable to expect otherwise.

Moreover, the Draft Report is incorrect in several areas of Section 7.1 in referring to the building block approach and options to directly control prices and revenue. Statements in this section do not reflect the legal view and are technically incorrect. For example, the Gas Access Regime does not require determinations to be based on the building block approach and price caps do not have to be reset to actual costs. Options that do reflect the intention of the law have been provided previously to the Commission by ENERGEX in the National Access Regime review and by Allgas in this review, including price-service offerings.

In the Ministerial decision revoking coverage of elements of the Moomba-Sydney Pipeline system, the Minister provided reasons which echo the Epic case. For example, he states:

> *"147. While an **efficient** tariff may deliver significantly lower gas prices to customers of gas transported by the MSP, the presumption behind the Council's analysis is one of a more or less permanently regulated pipeline facing diminishing regulated tariffs down to long term economic costs. Maintaining access regulation to push tariffs down to a theoretical perfect competition level will not serve the long term public benefit if this results in under-investment in gas pipelines and an associated inability to promote competitive gas supplies. In such circumstances, regulation would become a surrogate for market competition and the costs (direct and indirect) are likely to exceed the long tem public benefit."*

Allgas has confirmed with the Minister's department that this rejection of the theoretical ideal was fully understood and intended in the Minister's decision.

Despite this clear statement and other reasons put by the Minister, it is understood that on 9 December 2003 the ACCC rejected a proposed tariff regime by the MSP and imposed its usual perfect competition model on the remaining covered part of the pipeline. As previously argued to the Productivity Commission in ENERGEX and Allgas submissions, regulatory decision-making has all the elements of the Principal-Agent problem, and must be contained in the new arrangements.

The other reason the first tier recommendation is unsustainable as it stands is that the cost of service methodology is, in any event, in such a parlous technical state that outcomes from determinations will abrogate a number of other objectives of the legislation. Allgas provided a copy to the Commission of a technical paper demolishing the CAPM methodology by Professors Fama and French. We also provided (Allgas November 2003) a paper by Professor Gray drawing out the implications of the Fama and French analysis. These implications were not mentioned in the Draft Report, although, to Allgas' knowledge, no one has yet laid a glove on the Fama and French conclusions. Indeed, the analysis has been accepted by many eminent economists worldwide (eg see The Economist, 7 June 2003 and the CAPM's "obituary"). That is, rather than being a "generally accepted" methodology as required by the Code, the CAPM is in fact generally derided by the experts. Allgas regards this omission in the Draft Report as another serious deficiency. As noted in the Allgas submission:

> *"The stark consequence of this reality (the technical problem of CAPM) is the likelihood of jeopardising the efficient, reliable and secure operations of multi-billion dollar energy enterprises vital to Australia's growth and development, while providing an essential service to the community."*

Yet this is precisely what the likely outcome of the Commission's first tier recommendation will be.

DEFICIENCY 2: MATTERS TO CONSIDER IN COMPETITION TEST

The recent judgement by Justice French in the Australian Gas Light Company v ACCC case has pointed to a quite different approach to competition under the Trades Practices Act to that recommended in the Draft Report. The recommendation could therefore become unsustainable at law. Loy Yang is the first case in which a final decision has been made under the substantially lessening competition test in Section 50 of the TPA referred to in the Draft Report. There is likely to be a range of implications from the judgement, including for defining markets, assessing competition and interpreting market power.

At the least, the concepts of competition and market power will need to be interpreted quite differently to the traditional ACCC approach (and to the recommendations derived from that approach in the Draft Report). In Allgas' view, the narrow structuralist approach adopted by the ACCC in the past will need to be replaced by an approach much closer to the sort of competition favoured in the Epic case, where competition will be judged on commercial realities and the likely operation of the competitive process over time as enacted by real world market participants. As Professor Round has advised Allgas (14 January 2004):

> *"The judgement also demonstrates a reluctance to accept anti-competitive concerns based simply on static economic theory, and a judicial preparedness to focus on what a prudent operator operating efficiently would do in accordance with sound commercial imperatives. Commercial realities and demonstrated market behaviours are to be given full weight."*

On 19 December 2003, Justice French found that AGL's intended acquisition of the Loy Yang Power Station Business is unlikely to substantially lessen competition in any relevant market. This case is the first time the ACCC has been challenged under S.50 and it is being seen as a landmark in competition law. Media commentary is also suggesting that the case will encourage the Federal Government to implement the flexible formal procedures recently recommended in the Dawson Review of the TPA. Dawson recommended a procedure where companies could, in effect, bypass the ACCC and go straight to the ACT on appeal.

Justice French considered the structuralist approach to defining the market, assessing market power and conducting the substantially lessening competition test as put by the ACCC. However, he appears to have taken a radically different approach, after exploring the origin of the test and making comparisons with the previous dominance test.

Thus, he takes a broader view of the product, temporal, geographic and functional dimensions of a market. He appears to apply little weight to most of the structural criteria usually applied by the ACCC and referred to by the Draft Report. Further, he appears to relegate the importance of market definition and modelled predictions of behaviour based on structural characteristics to a low level. For instance, the ACCC's contentions that the acquisition would encourage "cascading vertical integration" and other anti-competitive effects were dismissed.

The traditional approach taken by the ACCC has been to rely on the elements of structure as predictors of performance in the structure – conduct – performance paradigm. It has used econometric modelling and economic experts of a certain persuasion to make these linkages, notwithstanding the broad empirical evidence worldwide that there is little or no such relationship between structure and performance.

Justice French has, in effect, changed the question inherent in the traditional approach and has answered it by relying on the actual behaviour of real world market participants. Relevant remarks in his judgement include:

- *Competition is expressed by "rivalrous market behaviour" which is a "process rather than a situation", and is not assessed by a "snapshot" view. (p.134);*

- *"The theatre of competition is a theatre of real actors and shadow actors (p.135)";*

- *"Competition so understood is conceptually distinct from the idea of the market and the elements of market structure which may constrain or facilitate it (p.135)."*

The fundamental question he addressed was, in effect, what is the problem in this market to which stopping the Loy Yang acquisition is the solution? This was answered not by addressing structural elements but by understanding how market participants behave now and how they would behave under the new commercial realities (that is, understanding the outcomes of the process of competition with and without the proposed acquisition – see p.135).

Justice French's judgement may be regarded as the appropriate future approach to assessing competition under the law (there is to be no appeal). It is suggested that the Productivity Commission revamps its recommended competition test along these lines. For instance,

- For the NCC to address the question: 'What is the problem in this market (say gas distribution in Queensland) that regulating the distribution businesses under tier 1 or tier 2 is the solution?

- The assessment process would then take evidence from participants about commercial realities and competitive market behaviour under the various scenarios.

- If the problem was minor, or actual and expected behaviour benign, there would be no coverage.

- If the problem was substantial and behaviour had been or could be expected to be less than that in workably competitive markets, tier 1 would be imposed.

- Conditions between these extremes would result in monitoring, with the threat of tier 1 if behaviour deteriorated.

DEFICIENCY 3: CURRENTLY COVERED, FIRST TIER

It is this need to demonstrate competitive market behaviour which gives rise to Allgas' third broad concern with the Commission's recommendations. There is circularity within the recommended two-tier structure which appears to abrogate natural justice principles. In practice, a pipeline business, which is currently covered under cost of service regulation, would have to show that it would increase economic efficiency if it wished to be governed by monitoring. Yet such 'proof' is impossible to provide as the cost of service regime itself precludes the achievement of such efficiency. This is Kafkaesque as proof for release from the first tier can only be provided by a behaviour that may arise from the act of release itself.

Minister Macfarlane's decision on MSP makes a series of similar points about circularity and behaviour. For example, he notes that NCC arguments in assessing coverage *"face a fundamental flaw":*

> *"It is essentially a circular proposition to suggest that because regulated tariffs may guarantee the lowest factor cost for inputs to the production process and provide other rights or obligations, such outcomes should then serve as a justification for access regulation." (para 150)*

And remarks further:

> *"The purpose of the Code is to regulate gas transmission pipelines that may otherwise be capable of exerting market power, not to establish an immutable regulatory framework for gas access in its own right." (para 152)*

Rather, the Minister sees regulation as an instrument of last resort which needs to be assessed on the basis – as did Justice French in Loy Yang – of actual market behaviours. Pertinent remarks by the Minister include the following:

> *"Under current Gas Code coverage criteria, there is relatively limited scope for actual market behaviour to serve as an indicator of whether pipeline services should or should not be regulated. The Code does not provide a ready benchmark for what might be regarded as competitive market behaviour. As noted earlier, this can lead to a presumption of regulation or to an inclination to consider access regulation as a precautionary rather than as a last step measure." (para 224)*

> *"Missing is a clear sense of the practices and principles expected of pipeline owners and operators to ensure that these pipeline services are provided in a competitive manner. It is not unreasonable for pipeline operators to be judged on their relative behaviour in the market place, the degree to which price transparency is maintained, whether the information requirements of*

market participants are met and the terms and conditions for various pipeline services clearly evident." (para 225)

"What is needed is to reverse the onus of proof for meeting the requirements for access regulation. Coverage should apply to those pipelines which are being managed contrary to competitive market principles. There should not be a presumption of access regulation, but industry should also be held more accountable for the market-based performance of its pipelines." (para 226)

Clearly, what the Minister is saying is the opposite to the direction of the recommendations in the Commission's Draft Report.

DEFICIENCY 4: REGULATORY PREFERENCE

Finally, in the GasNet Appeal Judgement, the Tribunal strongly reinforced the findings in the Epic Energy appeal that, under the Gas Code, the task of the regulator is to assess whether the Access Arrangement (AA), including the reference tariffs proposed by business, is consistent with the purpose of the Code. That is, if the proposed AA is within the statutory objectives of the law, it should be accepted. The regulator may not (as traditionally occurs) substitute some other more favoured outcome. Thus, at para 29 the Tribunal notes:

"…it is beyond the power of the Relevant Regulator not to approve the proposed AA simply because it prefers a different AA which it believes would better achieve the Relevant Regulator's understanding of the statutory objectives of the Law".

This point is reinforced in relation to the issue of a proposed rate of return, at para 42, where the Tribunal remarks that it is not the task of the regulator to determine a return but to determine whether the proposed AA in its treatment of the rate of return is consistent with the provisions of the Code. This presumably refers to cases where, as with GasNet, the business has selected cost of service over a price path.

The Tribunal's judgement on GasNet has several implications for the way regulation is currently applied and for the Draft Report's recommendations. One implication is that regulators should properly provide for uncertainties of the CAPM methodology, asymmetric risks and extraordinary events if CAPM is proposed by a business and its customers. This is also evident in the Tribunal's judgement on the application by Epic Energy, South Australia in 2003. As Allgas argued in its November 2003 submission (an argument ignored in the Draft Report), taking the analyses of Professors Fama, French and Gray together, the implication would be for a rate of return at least 50% higher than rates currently determined by regulators to cover the uncertainties and risks. This is in line with the estimate by Professor Glen Boyle of Otago University, who considered a margin of at least three percentage points over WACC to allow for the inherent miscalculations and bias of the CAPM methodology. In addition, KPMG has assessed that the regulated cost of equity should be increased by 1 percent to reflect diversifiable risks.

All this indicates that a typical rate of return of, say, 7.5 percent currently determined by regulators should be increased to around 11 percent. Even at this level, 5 per cent of regulated companies could lose money or fail simply because of the flaws in

the CAPM methodology. Consequently, some proposals by businesses might legitimately be higher if sufficient investment and risk taking is to be encouraged.

As remarked by the Minister in the Moomba-Sydney Pipeline case,

> *"148. Increasing investment in gas transmission is a key indicator of more competitive market conditions developing downstream. Pipeline investors who perceive that access regulation has not taken proper account of commercial and market risks and has prevented them from earning reasonable returns on their investment, will either not develop an existing pipeline or only build a new pipeline fit for purpose. Such outcomes would do little to assist in promoting competition in downstream gas markets longer term."*

As the legal implications of Epic, Loy Yang, Moomba-Sydney and GasNet become better understood, it is likely that regulated businesses will propose regulatory arrangements other than cost of service which are designed to replicate the outcome of a workably competitive market. It is our understanding that regulators do not have the power to gainsay such proposals.

In considering the competition test in Loy Yang, Justice French said that the process of competition would produce price-product-service offerings which reflected what customers wanted, with prices that reflected demand and supply (p.134). Similarly, Professor Round has said that the regulatory task is to find out how the market works, what consumers want and how sellers can best deliver these packages (see Round p.5 in Allgas submission, November 2003).

All this reinforces Allgas' contention that both tiers 1 and 2 must seek to replicate workable competition, and in doing so, the outcomes could be similar.

THE WAY FORWARD

In Allgas' second submission (November 2003), Professor Round notes that:

> *"There can be no doubt that the Trade Practices Act and all of the Codes associated with it seek to promote the achievement in markets of outcomes consistent with those that would be achieved in the presence of these types of independent interfirm rivalry. They do not either explicitly or implicitly promote a goal of welfare maximisation predicated upon the necessary presence of perfectly competitive markets. Nor should they, if the goal is to enhance social welfare in the long run where market dynamics are taken into account, and where price competition, the sole driver to equilibrium in perfectly competitive markets, is far less a systematic feature of real world competitive processes than are process and product innovation and the desire by firms to secure lasting competitive advantages by offering buyers a range of price/product/service packages." (p11)*

The sorts of behaviours and outcomes that can be expected from real world competitive processes are then examined, with reference to writers such as Michael Porter, John Kay and Sharon Oster. Round notes that:

> *"These positions are entirely consistent with the attitude of the High Court of Australia in Queensland Wire Industries Pty Ltd v The Broken Hill Proprietary Co Ltd & Anor (1989) ATPR 40-925, where it noted (at p50,011) that 'Competition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away.' The notion of competition that has been endorsed by the High Court is the modern behavioural model espoused by the WASC, and not the sterile static structural model of perfect competition. An enforcement model for competition policy based on this standard will not likely produce maximum social welfare in the long run. It will create large sunk deadweight losses and will provide the wrong signals for dynamic market performance.*
>
> *Taken all together, these assessments suggest that what must be changed is not so much the underlying law and codes governing market conduct in Australia, but the interpretation by enforcers of what it is that constitutes a competitive market. This is precisely what has been suggested by the WASC. A competitive market for practical purposes is one in which the competitive process is at work; it is not one that features the static properties of the textbook model of perfect competition, which in effect only describes where a market will eventually settle if a series of unrealistic conditions are met. Such an equilibrium will in all likelihood never be reached anyhow, as market conditions are constantly changing." (p12)*

Professor Round concludes that:

> *"Theory has shown that even a monopoly market can be regarded as contestable. Similarly, a regulated utility provider with no direct rivals for its energy output could still produce a selling package with price/product/service attributes, or a range of such packages, that offers the market an outcome little or no different from what would be observed in a market where several firms engaged in good hard commercial rivalry that was socially efficient.*
>
> *It is also crucial to have an operating framework for competition that is flexible enough to cope with the wide variety of dynamic corporate strategies that are called into play as part of the competitive process. There cannot exist a simple 'one-size-fits-all' model. Different firms will have different ways of seeking to attract and retain customers, and a given firm will likely be changing its tactics at different points of time as it responds to varying market conditions. To assess all behaviour through the behavioural straightjacket of the perfectly competitive model that focuses on the short run is analytically incorrect and, as well, leads to policy enforcement with serious implications for social welfare. The approach of the WASC, in contrast, by invoking the notion of workable competition, while providing no magic formula for regulation, at least opens regulators' eyes to the need for flexibility and a careful dynamic multi-period analysis of the unique characteristics of each market." (p13)*

Taking all these matters into account, an approach to reform which is consistent with the intent and concepts clarified by legal processes would appear to be as follows.

- Tier 1 to be modified to require regulators to produce workably competitive outcomes where prices are set by the regulator.
  - covered companies could propose a charging regime or a package of price/product/service offerings, but if the regulator deemed these to fail the objects clause, a pricing regime would be imposed that replicated the concept of workable competition;
  - a business that continued to fail to perform and serve its customers could expect a lower rate of return.

- Declare all currently covered pipelines and distribution networks under tier 2 for five years, with new pipelines and networks subject to the four tests proposed in the Draft Report.
  - covered companies subjected to price reviews are starting from the point of not abusing their market power;
  - the focus of the monitoring regime would be whether or not the regulated company has put forward a charging regime, or a package of price/product/service offerings, that is consistent with what could be observed in a workably competitive market;
  - such companies would operate under the 'threat' of being dropped to tier 1 if they did not perform.

- Coverage and transition between the tiers (in either direction) would be subject to the four tests proposed in the Draft Report. However,
  - the competition test would be applied in the manner of Justice French in the Loy Yang case;
  - the efficiency test would be applied in the manner of the Epic case, in which economic efficiency is seen as being achieved by the process of workable competition. This process will be price related, but will be generally based on non-price strategies like product differentiation, product and process innovation, provision of information, and other dynamic initiatives needed to survive in markets where rivals are few and where effective potential entry is a threat.

It is a fact of life that most regulated companies have concerns about the ability of regulatory agencies to apply the intent and meaning of the law.

- It is critical to any reform proposals that regulated companies have access to merits appeal by the Australian Competition Tribunal.

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