

## On AusCID Letterhead

3 March 2004

Mr A Hinton  
Presiding Commissioner – Review of  
Gas Access Regime  
Productivity Commission  
Locked Bag 2 Collins Street East  
MELBOURNE VIC 8003

Dear Mr Hinton

### **Response to Draft Report of the Review of the Gas Access Regime**

AusCID welcomes the release of the Commission's Draft Report of the Review of the Gas Access Regime and supports the broad thrust of its conclusions and recommendations. Investors will be particularly pleased that a consistent stream of policy thinking has emerged from the Commission through this review and others such as the Reviews of the National Access Regime, the Prices Surveillance Act and Airport Price Regulation and that its approach is being steadily adopted by governments.

In particular, AusCID supports the Commission's recommendations on

- Restructuring the objectives of the Code.
- Refocusing the coverage criteria in the Code towards the pursuit of economic efficiency.
- Continuing the separation of declaration from regulation and maintaining the public policy position of Ministers.
- The provision of binding coverage rulings for greenfields investments.

In several areas, however, we would encourage the Commission to extend the scope of its analysis. I have set these out briefly below.

### **Criteria for determining regulatory form**

AusCID strongly supports the Commission's recommendation that price monitoring be adopted for those pipelines where access may materially increase competition but where price regulation is not appropriate. However, the recommendations made by the Commission in this regard leave significant discretion in the hands of the National Competition Council. Whether a pipeline is subject to monitoring or reference tariffs would largely be a matter of subjective judgement. It is our view that the difference between "material" and "substantial" is open to wide interpretation in an operational sense. It is the bitter experience of AusCID members that, when left with discretion, regulators (and we see the NCC largely as a regulator in this environment) will tend to tighter rather than looser forms of regulation.

To give better effect to what would be governments' policy intent, it would be appropriate for the Code to provide some criteria, or at least relevant matters to consider, as a guide to the NCC in its deliberations. This could be expected not only to reduce the imposition of regulation when it was not warranted but also to reduce the scope for ambiguity that may lead to costly reviews.

We would encourage the Commission to consider whether such an approach would be helpful and if so consider what form such criteria might take.

## **Reference tariffs and price regulation**

AusCID welcomes the Commission's recommendations in regard to setting reference tariff policy. However, it is our view that the Commission's proposals do not go far enough in addressing the sorts of regulatory opportunism that have recently been the subject of legal challenge to regulators decisions.

The Commission made a number of recommendations on how to improve the cost-effectiveness of the current regulatory approach but no recommendations were made on how the approval of reference tariffs would operate despite the Commission's criticism of the model used. It is important to ensure that in the development of a new approach to the Code, if firm views remain on the setting of reference tariffs, that this approach encourages dynamic efficiency.

In particular, there is a need to establish clear principles for the establishment of the parameters used to calculate the cost of capital. There have been a number of recent legal decisions that have clarified the issue of the application of the CAPM model that need to be incorporated into the new Code to ensure that any companies left in Tier 1 still are encouraged to be dynamically efficient. Cases such as the Epic's appeal in the Supreme Court of Western Australia, the Federal Court decision relating to AGL's acquisition of Loy Yang and Minister MacFarlane's decision revoking code coverage of a substantial portion of the Moomba-Sydney pipeline all have revolved around the view that perfectly competitive frameworks are not appropriate for viewing the Australian energy industry.

Rather, a workably competitive model provides the appropriate framework. An approach based on workable competition invalidates the use of the CAPM model that is based on the assumptions of perfect competitive equilibrium. This presents a major problem for the approval of reference tariffs in a workably competitive market. An approach which meets the criteria of a workably competitive market but allows the CAPM to be used as a check on rates of return would use a range of CAPM measures that was within acceptable commercial boundaries. Recent legal precedents also support such an approach that could apply to companies regulated under Tier 1.

AusCID believes that the Commission should recommend that the concept of "workable competition" be incorporated into the proposed objects clause as the relevant market test for Tier 1 and 2 regulated companies.

Further, to remove the uncertainty that has been the subject of recent legal action, the Commission should also recommend that a new section be placed in the Gas Code (Reference Tariff Approval) dealing with how the CAPM model is to be used in

determining reference tariffs in the context of a workably competitive market for Tier 1 companies.

Similarly, regulators have recently been involved in a race to the bottom when considering elements of the cost base. Again, much would be gained if the Code set out a richer framework to guide regulators in their consideration of the cost base in those cases where reference tariffs are required. The Commission should recommend that the lowest cost of capital or operational equipment is not a requirement under the Gas Code and note that there are numerous reasons, why the lowest cost for equipment should not be used, for example, in term of quality, delivery capability and timeliness.

### **Wider energy policy issues**

The Commission is aware of the wider policy debate that is currently taking place in relation to the energy sector. Whilst we understand that it is not within the scope of its current review, AusCID believes it would be of significant value to the industry and policy makers if the Commission could give some consideration to how the principles it is seeking to establish in this inquiry may be transferred to the electricity industry.

If you wish to discuss these issues further, please feel free to call either myself or Dr Warren Mundy on 0409 911 554.

Yours sincerely

Dennis O'Neill  
Chief Executive Officer