Submission to the Productivity Commission

Review of the Gas Access Regime

Response to Draft Report

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1. Overview

The Energy Networks Association (ENA) welcomes the Productivity Commission's Draft Report in its *Review of the Gas Access Regime* (Draft Report).

The ENA - which continues the previous participation of Australian Gas Association in the review - is a new national representative body formed to represent the interests of gas and electricity distribution businesses. It sees achieving substantial reforms to the gas access regime as a core policy priority in the energy sector over the next two years.

The ENA supports a large number of the findings and recommendations of the Commission's Draft Report but considers it vitally important that the Commission understands that the energy network sector still has a number of core concerns which are not addressed by the Draft Report.

These concerns are:

- the restriction of recommendations for substantial reform to the areas of new investment and coverage issues does not adequately address the potential for ongoing underinvestment in the expansion and operation of *existing* gas infrastructure or the identified flaws of cost-based approaches to regulation adopted by regulatory authorities

- the need to recognise recent judicial rulings and other precedents that have key implications for current approaches to access pricing regulation and developing proposals to alter the regime

- several proposals and options mooted by the Commission have the potential to lead to more intrusive, costly and error prone regulatory approaches and move the regime even further from its intended 'light-handed' approach

- delays in implementation may result in substantial time elapsing before the regulatory framework is actually improved

This last concern highlights the ENA's overarching view that the Commission's recommendations represent a strongly positive step in recognising the medium-term interests of existing and potential gas consumers in having access to growing and reliable gas distribution networks.

The ENA has set out a number of detailed recommendations which it requests the Commission consider in the remainder of the review period. These recommendations are set out in the relevant sections of the submission, which itself closely follows the structure of the Draft Report.

1.1 Background

This submission responds to the Productivity Commission's *Review of the Gas Access Regime – Draft Report* released in December 2003.

The Energy Networks Association is a newly-established national representative body for gas and electricity distribution networks. Energy network businesses deliver electricity and gas to over 12 million customer connections across Australia through approximately 800 000 kilometres of electricity lines and 75 000 kilometres of gas distribution pipelines. Collectively, gas distribution networks form the largest class of assets impacted by the gas access regime.

Energy distribution networks are valued at more than $28 billion, and each year these network businesses undertake capital investment of more than $2 billion in network expansion, reinforcement, and greenfield extensions.

The ENA was formally established in December 2003 by agreement between all Australian energy network businesses. Its participation in the Commission's current inquiry replaces that of the previous Australian Gas Association.

2. Core responses to the Commission's proposals

The ENA supports the majority of recommendations and findings made in the Draft Report, but has significant concerns in some areas.

The ENA considers it important that the core concerns of the owners of regulated gas infrastructure assets are addressed in the Commission's final report. These concerns fall largely into three categories. First, areas where the Commission's inquiries and findings have not led to recommendations that will address fundamental deficiencies in the regime and its application. Second, recommendations and findings that have the potential to lead to unjustified increases in costs, intrusion and inefficiencies compared to the existing regime; and third, areas where implementation and operational issues are left unresolved

Core Concern 1 – Need to protect ongoing investment in existing assets, and improve the operation of the cost-based tier of regulation

The Commission has made a number of proposals which are heavily focused on:

- removing aspects of the current regime that adversely impact on new infrastructure (e.g. through recommendations on binding coverage rulings and seeking a higher 'bar' for coverage)

- removing potentially adverse pricing elements of the regime from assets where intrusive price regulation is not deemed necessary (e.g. the price monitoring option and a higher 'bar' for coverage)

While these proposals are supported, the Commission's Draft Report does not offer a comprehensive set of recommendations relating to other critical areas of the operation of the existing regime, in particular the need to:

- address potential underinvestment in the expansion and operation of existing gas infrastructure

- overcome the identified flaws of the existing cost-based approach to regulation adopted by regulatory authorities, particularly in the light of the Commission's draft finding that a cost-based tier of pricing regulation should remain as part of the regime

Relying on specific measures to promote new investment and a potential narrowing of the scope of the application of access pricing regulation risks the outcomes of the final report

failing to meaningfully address the largest potential area for regulatory failure under the existing regime.

This point is illustrated by a consideration of the magnitudes of difference that exist between the level of annual new investment that would benefit under the Commission's proposals for binding coverage rulings and improved coverage arrangements, and the level of existing sunk capital investment. New investment in gas transmission pipelines has averaged approximately $500 million per annum over the past five years.[1] By contrast, the total value of gas distribution networks and transmission pipelines in Australia is at least $10.6 billion. That is, new transmission pipeline investment likely to substantially benefit from a range of the Commission's recommendations constitutes approximately five per cent of total existing gas infrastructure (i.e. sunk capital).

The strong need to ensure that ongoing investment in the operation and growth of gas distribution networks is facilitated becomes even clearer when the scope of assets currently covered by the regime is considered. At present, approximately $8.5 billion of gas infrastructure is subject to access pricing regulation under the existing regime. Of that $8.5 billion of infrastructure, approximately $5.5 billion - or nearly two-thirds – consists of gas distribution networks.

Unless recommendations specifically address the negative impacts of the regime on existing gas distribution assets (in addition to the positive incentives in the Draft Report for greenfield gas transmission pipelines and pipelines operating in other competitive environments) the Commission risks failing to address potential ongoing underinvestment in the largest asset class under the regime: existing network assets directly serving 3.5 million households and businesses.

To address the negative impacts of the existing regime on gas distribution networks specific additional recommendations are needed. The specific additional recommendations that are required are detailed throughout this report, however, they include:

- a specific recommendation on the need to ensure future access pricing for existing assets is rebalanced to ensure recognition of the medium-term interests of the community in having access to a growing and reliable gas distribution network

- modifications to the Commission's proposed pricing principles

- provision for the equal sharing of efficiencies gains achieved by service providers with consumers through time

In summary, to lower the potential for regulatory error or failure to lead to medium-term underinvestment, it is critical that there are specific improvements in the regime's treatment of existing gas distribution network assets, which constitute the largest single class of assets under the regime.

Core Concern 2 – Need to recognise and integrate judicial precedents

A second core concern is that there have been a number of key judicial rulings and other decisions that have occurred shortly prior to the release of the Draft Report, or immediately following it, which the Commission has not been able to fully integrate into its findings and recommendations.

This fact is beyond the Commission's control, but ENA wishes to highlight its fundamental concern that the principles established by these rulings (for example in the GasNet and Epic Energy Moomba-Adelaide Pipeline appeals) are taken into account by the Commission and considered and incorporated into the finalisation of its recommendations and findings.

[1] Table 5.13 in Australian Gas Association *Gas Statistics Australia*, February 2003, p.58

To assist the Commission in this regard Section 3 of this submission sets out some of the key implications of the relevant decisions.

Core Concern 3 – Proposals that move the regime further from the original model of 'light-handed' regulation

The ENA is concerned that several Draft Recommendations, Draft Findings and requests for information suggest that the Commission is considering moves that would significantly increase the level of regulatory intrusion for regulated gas businesses.

This is despite a lack of compelling evidence that existing provisions of the National Gas Code are inadequate to deal with the range of issues suggested by advocates of greater regulatory powers as justifying the moves.

Taken collectively, new information collection powers to force the collection of new data within Access Arrangement periods, subjecting affiliated asset management businesses to detailed and direct cost oversight by regulatory authorities, and the direct application of ring fencing provisions to activities of asset management businesses with no scope to lessen competition, constitute a significant departure from 'light-handed' and efficient regulation. The implementation of these recommendations and mooted options would significantly increase the existing regulatory burden which the Commission has already found to be in excess of that justified by the potential market impact of the current regime.[2]

The ENA is concerned that, depending on the approach adopted by future coverage bodies and decision-makers, some regulated gas businesses could actually face an increase in regulatory compliance costs through the implementation of the proposals and options mooted by the Commission, not a reduction in heavy-handed regulatory approaches.

Core Concern 4 – Need to ensure timely implementation

A final core concern of regulated energy networks is the timely implementation of the broadly positive package of findings and recommendations set out by the Commission.

The need for timely implementation of the Commission's recommendations is highlighted by the time taken to finalised an Australian government response to the Productivity Commission's previous Review of the National Access Regime. Twenty-nine months passed from the issuing of the Final Report of that review to announcement of a finalised government response. Drafting, inter-governmental negotiation and passage of legislation to enact the final government response will further extend this significant delay.

For this reason the ENA urges the Commission and Australian governments to set out a clear timeline and process for implementation of the recommended improvements to the regime which involves industry. The ENA considers that industry participation and assistance can best be achieved through the use of an industry-government partnership, such as informed the initial development of the gas access regime (through such bodies as the Gas Reform Implementation Group and Gas Reform Taskforce).

The Commission is also encouraged to make recommendations and findings on the relationship between the current *Review of the Gas Access Regime*, the continued development of the new Australian Energy Regulator, and the need to ensure a modern regulatory regime is enshrined in these new structures.

[2] See Draft Finding 7.6 and Draft Finding 7.3 in Productivity Commission *Review of the Gas Access Regime – Draft Report*, December 2003, p.xliii and xlii

3. Recent judicial developments relevant to the regime

Since the release of the Commission's Draft Report there have been a number of key judicial rulings on appeals under the existing gas access regime. These judicial precedents have important consequences for the conduct of access pricing regulation under the existing regime, and also have implications for the shape and implementation of the Commission's recommendations.

Key precedents under the gas access regime since the release of the Draft Report include the Australian Competition Tribunal's rulings in:

- A*pplication of GasNet Australia (Operations) Pty Ltd* in relation to a decision by the ACCC to draft and impose an Access Arrangement for the Victorian gas transmission system owned by GasNet Australia (GasNet case)

- *Application of Epic Energy South Australia Pty Ltd* in relation to a decision by the ACCC to draft and impose an Access Arrangement for the Moomba-Adelaide Pipeline System (MAPS case)

In addition there have been a number of other key decisions and judicial precedents that occurred either following the Draft Report or at a time when much of the Draft Report had been substantially finalised. These include:

- the Federal Court action regarding AGL's proposed participation in the sale of the Loy Yang A power station[3]

- the decision by the Minister for Industry, Tourism and Resources to remove coverage over substantial sections of the Moomba-Sydney Pipeline

All of these decisions and outcomes also need to be considered against the range of existing judicial precedents, in particular, the August 2002 judgement of the WA Supreme Court in relation to Epic Energy's Dampier to Bunbury pipeline which established, *inter alia*, that the outcomes of a workably competitive market are the appropriate benchmark against which to assess proposed regulated tariffs.[4]

GasNet and MAPS appeal decisions

The GasNet and MAPS appeal decisions contain an important set of practical guidance and principles for regulatory decision-making under the regime. The ENA urges the Commission to carefully consider not just the outcomes and facts of these decisions, but the broader implications of the judgements for the application of the current regime and the implementation of amendments to the regime.

The ENA considers that the principles established in the two decisions and the guidance they offer to regulatory authorities could play an important complementary role to the Commission's recommendations for reforms to the regime. It is critical that reforms to the regime draw on relevant judicial precedents, and not be formulated in isolation from them.

The ENA believes that the Commission should take into account the GasNet and MAPS decisions in preparing its final report. The ENA considers that useful guidance can be derived from the findings and principles of the Australian Competition Tribunal in these decisions. Areas where important guidance from these decisions can be gain include:

[3] Note – This appeal decision was not related to third party access, however, it contained generic commentary on regulatory approaches and assessments of market dynamics that have relevance to the application of access regulation.
[4] *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [128]

Limits on the role of the regulatory body under the regime

- it is not the role of the regulatory body to determine the regulatory rate of return to be applied, instead its role is to determine whether the rate proposed by the service provider is consistent with the provisions of the National Gas Code (Section 8.30-8.31)[5]

- regulatory bodies cannot substitute their preferred cost of capital estimation approaches for reasonable approaches proposed by the service provider which are based on the correct application of conventional cost of capital models[6]

- there are no single 'correct' values for most of the parameters used in setting reference tariffs[7]

- where a service provider has proposed an Access Arrangement including reference tariffs that meet the requirements of Section 8.1, the regulatory authority must accept the tariffs and Access Arrangement and will be acting 'beyond powers' if it rejects the proposed tariffs solely on the basis that it prefers a different Access Arrangement (and/or parameter values) because it considers that this would better achieve the regulatory authorities' understanding of the objectives of the regime[8]

- the power to amend an Access Arrangement does not arise until a regulator has determined a proposed Access Arrangement is non-compliant with the regime[9]

- it is the responsibility of the service provider to draft an Access Arrangement and propose tariffs that are consistent with Section 8.1 of the Code.[10]

Selection of estimates where a range of values exist

- regulatory authorities must provide a clear and appropriate rationale for adopting either the lowest or low single point estimates where there exists a credible range of potential values[11]

- neither the pricing objectives of replicating the outcomes of competitive markets or allowing the recovery of 'efficient' costs under the National Gas Code (see Section 8.1 (a) and (b)) require a regulatory authority to select the lowest cost estimate in a credible range of potential values[12]

- selecting the lowest or a low single point value from a credible range of potential values for a cost estimate subjects the service provider to an asymmetric risk of regulatory error and a prudent service provider would not base future investment planning on accessing lowest cost products in the lowest cost market[13]

Assessments of market power and coverage under the regime

- decisions based on the use of theoretical arguments regarding either the presence of market power or its potential abuse that are unsupported by clear market analysis are likely to be found to be unreasonable and overturned[14]

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[5] *Application by GasNet Australia (Operations) Pty Ltd* [2003] ACompT 6 [42]
[6] *Application by GasNet Australia (Operations) Pty Ltd* [2003] ACompT 6 [42-48]
[7] *Application by GasNet Australia (Operations) Pty Ltd* [2003] ACompT 6 [29] Cf. Draft Finding 7.2 in Productivity Commission (December 2003), p.xlii
[8] *Application by GasNet Australia (Operations) Pty Ltd* [2003] ACompT 6 [29-30]
[9] In particular, Section 2.24 and Section 8.1-2. See *Application by GasNet Australia (Operations) Pty Ltd* [2003] ACompT 6 [29-30]
[10] *Application by GasNet Australia (Operations) Pty Ltd* [2003] ACompT 6 [36-37]
[11] *Application of Epic Energy South Australia Pty Ltd* [2003] ACompT5 [27, 32, 84]
[12] *Application of Epic Energy South Australia Pty Ltd* [2003] ACompT5 [92]
[13] *Application of Epic Energy South Australia Pty Ltd* [2003] ACompT5 [63, 94]
[14] *Application of Epic Energy South Australia Pty Ltd* [2003] ACompT5 [44, 48]

- the mere presence of excess demand for a service is not necessary or sufficient to prove that market power exists, excess demand is only one indicator of potential market power[15]

- coverage under the National Gas Code (including of system expansions) should only be pursued if market power that is 'non-transient and non-trivial' is shown to be present and that a 'not trivial' increase in competition can be expected to follow[16]

- a regulator under the National Gas Code needs to assess Section 2.24 factors (including the legitimate business interests of the service provider) in making a decision on coverage of system expansions[17]

- in the absence of detailed market and factual analysis, the theoretical possibility of the potential abuse of market power is insufficient for a regulatory authority to require a system expansion to be covered.[18]

Taken collectively, ENA members consider that this set of precedents has the potential to significantly improve the application of the existing regime and assist in developing amendments to the regime by establishing that:

- the core principle is that under the gas access regime it is the service provider that proposes terms and conditions of access which are assessed against a set of objectives and principles, and that the regime has incorrectly been applied by regulators with an undue emphasis on setting prices

- under workably competitive markets and existing cost of capital models there are a range of access pricing outcomes and individual parameter values that will meet the Code's requirements, and arbitrary point estimations of cost of capital parameters or a deterministic approach to approving access prices are inconsistent with the Code

- regulatory authorities must clearly justify instances where they rely on values in price setting models that fall in the lower bounds of a credible range, and, where they adopt these values for the purpose of approving tariffs, must specifically address the asymmetric risk of regulatory error which this places on service providers

- reliance by regulatory authorities on economic theory and constructs as primary evidence in decisions which materially impact on the property rights of service providers, without supporting evidence drawn from analysis of the relevant market and the actual conduct of market participants, is flawed.

The ENA urges the Commission to consider the benefits of incorporating the detailed findings of principle of the Australian Competition Tribunal in the GasNet and MAPS cases into its final report and recommendations. Practical ways of achieving this include:

- recognising the underpinning concept of 'workable competition' in appropriate access pricing decisions

- maintaining and reinforcing the 'propose-respond' model established by the National Gas Code

- explicitly rejecting the need for regulatory authorities to substitute service provider proposed values with the regulator's own preferred values in the case of a range of uncertain and difficult to measure parameters

[15] *Application of Epic Energy South Australia Pty Ltd* [2003] ACompT5 [102] cf. Productivity Commission (December 2003), p.179
[16] *Application of Epic Energy South Australia Pty Ltd* [2003] ACompT5 [104, 113] Note this is similar to key recommendations made by the Productivity Commission on coverage, see Draft Finding 6.1 and 6.2 in Productivity Commission (December 2003), p.156 and p.173
[17] *Application of Epic Energy South Australia Pty Ltd* [2003] ACompT5 [48]
[18] *Application of Epic Energy South Australia Pty Ltd* [2003] ACompT5 [120]

- adopting starting presumptions on the coverage of assets that are based on actual market evidence, not just economic theory or a presumptions regarding potential abuse of market power.

4. Is the gas access regime working?

The Commission identifies in its Draft Report that the gas access regime has significant deficiencies and requires improvements.[19] In particular, the Commission supports the contentions of regulated gas businesses that the regime is having the effect of deterring and distorting investment.[20]

This recognition of the flawed nature and deleterious impact of the current regime is welcomed by the ENA. In view of these findings, ENA considers that the most productive contribution participants can make in the remainder of the inquiry and the process of implementation of its recommendations is to focus on how timely and practical improvements can be made to the regime. The efficacy of the existing regime has been an area on which parties have devoted considerable resources and made at times polarised claims. The ENA considers that the position that the gas access regime was functioning effectively, and did not require any type of review, is inconsistent with the weight of evidence presented in submissions to the inquiry.

An additional aspect of the Commission's review of the existing regime which ENA strongly supports is the Commission's finding that price regulation should only apply where there is substantial market power.[21] As the Commission notes, competitive developments in the gas network and pipeline sectors (including the increasing development of retail competition) means that the regime must be responsive to potential scope for the removal of economic regulation altogether in the future.[22] The ENA considers that this development is most likely to first manifest itself in relation to several gas distribution networks serving smaller markets in areas with relatively low gas throughput and/or warm climate. As an example, ENA would consider gas distribution networks serving Queensland and Tasmania as the types of networks that lack substantial market power and where the costs of regulation clearly outweigh any possible benefits. Indeed, as Professor Littlechild (the architect of the existing model of CPI-X price cap regulation) notes, due to competition from electricity the need for regulation of any gas distribution services may be questionable.[23]

5. Objectives and object clause

The ENA broadly supports the proposed objects clause recommended by the Productivity Commission for an amended gas access regime. In ENA's view, streamlining and clarification of the objectives sought by the community through the gas access regime will play an important role in promoting accountability and transparency in the operation of the regime.

The benefits from clarification and a formal binding statement of the objectives of the regime were widely recognised by parties in the inquiry – including regulated energy businesses, regulatory authorities and energy users.[24] Most participants in the inquiry appear to consider that providing a clear set of guiding objectives will enhance the effectiveness of the regime and its outcomes.

It needs to be recognised, however, that not all parties share this view. For example, the ACCC has raised the possibility that a revised objects clause would have no impact on the

[19] Productivity Commission (December 2003), p.130
[20] Draft Finding 4.3 in Productivity Commission (December 2003), p.109
[21] Draft Finding 4.5 in Productivity Commission (December 2003), p.114
[22] Draft Finding 2.3 in Productivity Commission (December 2003), p.49
[23] Productivity Commission (December 2003), p.258
[24] Productivity Commission (December 2003), p.141

approach it adopts in applying the regime.[25] This highlights the need to ensure that undue emphasis is not placed on changes to the objects clause of the regime as the sole mechanism for addressing the underlying negative impacts of current access pricing approaches (such as a focus on the short-term interests of existing consumers). It also illustrates the potential for repetition of an issue that characterised the first period of the regime - a disconnect between the purpose of the regime as understood by stakeholders and the community, and the implementation of the regime by regulatory authorities informed by their own institutional imperatives and views of the objectives of the regime.[26] If the ACCC, as a potential constituent element of a future single national energy regulator, considers that the Commission's recommended objects clause would not alter their regulatory approach or processes to any degree, there is clearly scope for identified deficiencies in the application of the regime and the disconnect between community and regulatory objectives for the regime to persist unless additional recommendations address the issue.

Economic efficiency and workable competition

The ENA supports the inclusion of the concept of 'economic efficiency' in the proposed objects clause. The use of the term 'economic efficiency' has several important benefits in the context of giving guidance on access pricing issues.

First, it clearly imports economic definitions of efficiency which typically recognise three distinct types of efficiency: productive, allocative and dynamic efficiencies. The clear referencing to the concept of dynamic efficiency (typically including management-induced efficiency, technological change and service offering innovation) has important implications for the future application of the regime, particularly its third party access pricing elements. This is because the existing and widely applied Capital Asset Pricing Model (CAPM) fails to recognise the role of dynamic efficiency, due to its fundamental assumptions being based on 'perfect equilibrium' or 'static' market conditions featuring no technological change. This aspect of the CAPM has been well recognised by experts and regulatory authorities alike, and has led to several trials of additional mechanisms to address the disincentives the model creates for dynamic efficiency gains.[27] Clearer recognition of the role of dynamic efficiency in the objects clause of the regime has the potential to positively signal to regulatory authorities that the theoretical economic models which have been applied in the past (based on a focus on static and allocative efficiency, and lacking any strong incentives for dynamic efficiencies) are inappropriate in the future.[28]

Second, the term incorporates a central tenet of the original policy framework of the Hilmer Committee and a range of supporting developments to date. One of the most important of these developments has been the Epic Energy case *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor.* A core principle established in this Epic Energy case was that the gas access regime should seek to replicate the outcomes of workably competitive markets rather than theoretical models of 'perfect competition', and that economic efficiency was the desired outcome of a workably competitive market.[29] The ENA considers that contrary to the ACCC's view that that the concept of workable competition provides little useful guidance to regulators, the concept of workable competition and its interrelationship with concepts of economic efficiency that are included in the proposed objects clause provide a fundamentally important underpinning for access pricing under the regime. In this context it is relevant to note that the ACCC has, since the release of the Draft Report, had a total of three significant regulatory decisions overturned by the Australian Competition Tribunal (in relation to two appeals under the gas access regime) and the Federal Court (on a more generic competition law issue) in which issues of workable competition were relevant.

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[25] See Productivity Commission *Review of the National Access Regime – Inquiry Report*, September 2001, p.140, see also Productivity Commission *Review of the Gas Access Regime*, Public Hearings transcript p.339

[26] This is commonly referred to as the 'principal-agent' dilemma. See also Banks, G. 'Competition regulation of infrastructure: getting the balance right' Presentation to IIR National Competition Policy Seven Years On, 14 March 2002 and Productivity Commission *Annual Report 2000-01,* February 2002, p.13-14

[27] See for example UK Office of Gas and Electricity Markets *Innovation and Registered Power Zones – Discussion Paper*, July 2003 <www.ofgem.gov.uk>

[28] See *Statement of Reasons - Ministerial decision on application for revocation of the Moomba-Sydney Pipeline*, paragraphs [147-148] <www.industry.gov.au>

[29] *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [125-127]

Workable competition has many direct and practical implications for access pricing which have the potential to complement the outcomes of the *Review of the Gas Access Regime*. For example, the Epic Energy case and workable competition establish that:

- the legitimate business interests of service providers should be given weight by regulators as a 'fundamental element' in assessing a proposed Access Arrangement

- there is no provision of the regime that supports the views of regulators that future revenues available to the regulated business must be no more than the efficient cost of delivering the service - there may be public policy grounds in either not distorting investment, or in protecting the legitimate business interests of regulated businesses, to allow the recovery of more than 'efficient' costs[30]

- regulatory authorities in assessing pricing proposals should consider the outcomes of 'workably competitive markets' (where, for example, innovation might lead to transient economic rents accruing to service providers)

- in the determination of third party access prices regulatory authorities should consider a wider range of political and social considerations, not simply economic theory or the outcomes of economic modeling based on theoretical constructs.[31]

The ENA considers these types of principles are entirely consistent with the direction of the Commission's Draft Report. As such it welcomes the Commission's proposed objects clause as incorporating concepts of economic efficiency, and by extension the key notion that the regime seeks to promote outcomes consistent with that which would occur in a workably competitive market.

Commission's proposed amendments to Section 2.24

The Commission has proposed substantially amending the existing Section 2.24 of the National Gas Code to remove the requirements for a regulatory authority to consider a range of potentially conflicting objectives set out in clauses (a)-(g).

The ENA does not support the removal from Section 2.24 of clause (a) which states that the regulator must take into account when assessing an Access Arrangement '…the Service Provider's legitimate business interests and investment in the Covered Pipeline'. While the ENA supports the streamlining of the range of existing potentially conflicting objectives set out in the regime, it considers the removal of this clause to be inappropriate for the following reasons:

- the clause represents the only clear recognition and requirement in the text of the National Gas Code that a regulator must consider the legitimate business interests of the service provider[32]

- substantial judicial precedents based on the clause have developed that complement the Commission's proposed actions to increase regulatory accountability, improve decision-making under the regime, and protect new and ongoing investment in gas networks and pipelines[33]

[30] *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [142, 206]
[31] *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [152-153]
[32] The recognition of the need for 'investment' in the proposed objects clause is (correctly) one that focuses on the interests of the community in investment. While the protection of investment in networks and pipelines is a core business interest of service providers, the legitimate business interests of service providers may rightly extend to other matters. See *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [130]
[33] As an example, the Epic Energy DBNGP case had as one of its fundamental elements that the regulatory authority had erred in law in not taking into account Section 2.24 (a) of the Code. The section was also considered in the ACT judgement on the Moomba-Adelaide Pipeline appeal.

- the interests of service providers under the gas access regime are different in kind to other interests detailed in Section 2.24 given substantial sunk capital investment in gas infrastructure and the need to provide adequate scope for ongoing investment

- removal of any requirement for a regulatory authority to consider a service provider's legitimate business interests is inconsistent with a regime which impacts substantially on the property rights of private investors and businesses[34]

- the removal of a requirement to consider the 'legitimate business interests' of service providers appears to be inconsistent with the minimum requirements necessary for a regime to be certified as effective established by the *Competition Principles Agreement 1995*.[35]

The ENA acknowledges that other elements of Section 2.24 are duplicatory in nature and should be removed. As an example, the ENA considers that Section 2.24 (f) (on the interests of users and prospective users) is duplicatory as the interests it seeks to protect are adequately addressed in the proposed object clause and the retaining of Section 2.24 (b) (protection of firm and binding contractual obligations).

ENA Recommendation

The ENA recommends that the Commission:

- recommend that for all coverage decisions and determinations under the gas access regime the relevant decision maker should be required to have regard to the formal and binding objects clause[36]

- acknowledges the key linkages between, and complementary nature of, the concepts of 'workable competition' and the term 'economic efficiency' which is incorporated into the proposed objects clause

- recommend the retention of a requirement for regulatory authorities to consider the legitimate business interests of service providers in Section 2.24 of the National Gas Code

6. Coverage issues

The ENA supports the Commission's recommendations for:

- a substantially higher minimum test for coverage under the gas access regime

- an addition of a test of whether coverage will increase overall economic efficiency (taking into account a range of costs and benefits)

- continued provision of a common coverage test accommodating both gas transmission and distribution network assets

- continued Ministerial involvement in coverage decisions

These recommendations should be included in the Commission's final report, and will assist in removing unnecessary costs of regulation from gas network and pipeline assets and

[34] Hilmer et al *National Competition Policy – Report by the Independent Committee of Inquiry*, August 1993, p.251
[35] See *Competition Principles Agreement 1995*, Section 6 (4) (i) (i)
[36] Cf. Recommendation 6.2 in Productivity Commission (September 2001), p.137 and cf. Draft Finding 5.1 and Draft Recommendation 5.1 in Productivity Commission *Review of the Gas Access Regime* (December 2002), p.142-147 where the intention appears to be similar.

addressing the substantial risk of regulatory failure that the unnecessary application of access pricing regulation to these assets currently incurs.

Scope for 'regulatory creep' under a two-tiered model

The ENA supports, in principle, the proposed two-tiered approach recommended by the Commission, but is concerned to ensure that there is not scope for inappropriate 'regulatory creep' to undermine the implementation of the Commission's model. The ENA is concerned at the potential for 'regulatory creep' to occur under the model as currently proposed, with assets potentially shifting multiple times through levels of coverage, non-coverage and different types of regulation, unless there are adequate safeguards to prevent this.

In particular, in relation to the arrangements for moving between the price monitoring and 'reference tariff' tier, the ENA considers that allowing any regulatory authority to lodge applications for changes in the level of coverage and form of regulation is highly inappropriate.

The appropriate role of regulatory authorities under the regulatory regime is to administer a set of transparent rules established by government. Involving regulatory bodies in becoming sponsors of more intrusive forms of regulation being imposed on particular service providers is inconsistent with that role. Such a situation is likely to promote a bias toward regulatory intervention, and create possible incentives on the coverage assessment body to recommend coverage on a wider range of assets than intended. Regulatory authorities acting as a proxy for existing users in applying for more intensive cost based regulation for assets is also likely to further reinforce the existing undesirable conflation between the roles of regulatory authorities as advocates for existing incumbent gas users and independent arbiters applying an access regime impartially. The ENA considers there is no policy rationale for not requiring there to be at least one genuine access seeker (an existing or prospective user of the pipeline) to request the imposition of more costly and intrusive forms of regulation that have a greater propensity than price monitoring to distort investment outcomes.

The ENA supports the Commission's proposal that the introduction of price monitoring for a network or pipeline would be for a minimum five year period. It is noted, however, that the potential remains for circumstances to arise where assets covered under the 'reference tariff' tier of regulation successfully apply to have coverage completely removed (for example, due to the development of a competing pipeline or presence of existing competing energy sources). Nonetheless, in the resulting state of non-coverage, it is open to any access seeker to seek coverage of the asset immediately following this decision, potentially creating significant uncertainty and costs for a service provider that has recently incurred substantial costs seeking revocation of coverage.[37] This situation could promote the unintended use of coverage applications as mechanisms for strategic behaviour for users. For these reasons, ENA considers that rulings of revocation should, like the price monitoring tier of coverage, remain in force for a minimum of five years.

The ENA also supports the concept of establishing that applicants seeking the coverage of new assets under the gas access regime, or the imposition of forms of regulation that the Commission has found to be more potentially costly to the community at large than non-regulation or price monitoring, must be genuine access seekers.[38] The ENA defers to other qualified and interested participants to set out the conditions that could be used to establish that an applicant is a *bona fide* access seeker.

Default presumption on level of coverage

An issue not addressed in the Draft Report is the appropriate initial form of regulation which should face existing assets under the gas access regime.

[37] See Productivity Commission (December 2003), p.256
[38] See Productivity Commission (December 2003), p.194 and p.256

The ENA considers that it is important for the effective implementation of the 'two-tiered' model proposed that this issue is considered and clear recommendations on it are made by the Commission.

Given the findings of the Commission in relation to the impact of the application of the existing regime on investment and the provision of gas infrastructure to communities, the ENA considers an appropriate recommendation is that in the initial five year period following the implementation of the Commission's two-tiered model, all networks and pipelines currently covered should be covered by the price monitoring regime. This would err in favour of allowing the actual competitive forces facing existing pipelines and networks that are detailed in Chapter 2 of the Commission's Draft Report to define the terms and conditions of non-discriminatory third party access. For a range of commercial and residential applications, for example, movements in gas transportation tariffs are restricted by the levels of existing regulated electricity tariffs. This approach would also remove the need for a separate coverage and 'form of regulation' decision in relation to each individual existing asset under an amended regime, that would be necessary if this starting presumption was not adopted, and which would be likely to result in high upfront costs.

Most importantly, the approach of commencing the new regime with assets covered under the price monitoring tier would avoid the key benefits from the Commission's recommendations regarding lighter handed regulation from being frustrated and dissipated through the application of the costly 'reference tariff' approach to all pipelines and networks currently covered. If this were to occur, it would repeat an acknowledged implementation failure of the existing gas access regime - the automatic coverage of all pipeline and network assets in 1997 by virtue of Schedule A of the *Gas Pipelines Access Law*. As the Commission has noted, the evidence is that this was a costly public policy error, which led to the need for around 20 costly and lengthy revocation processes (in some cases, costing the equivalent of up to 23 per cent of the total annual revenue of the asset concerned).[39]

Scope for a bias to increased levels of overall coverage

A final concern of the ENA on coverage is that it anticipates that without explicit guidance and adequate accountability mechanisms it is likely that the existing coverage body – the National Competition Council (NCC) - may recommend price monitoring apply to a smaller number of assets than the Commission is likely to consider appropriate. This is ENA's initial assessment based on the NCC's:

- draft and final recommendations for coverage of the Moomba-Sydney Pipeline which operates in competition with the Eastern Gas Pipeline, recently overturned and critiqued in detail by the Federal Minister for Industry, Tourism and Resources

- draft and final recommendations for coverage of the Eastern Gas Pipeline following its construction in competition with the existing Moomba-Sydney Pipeline, and the overturning of a Ministerial decision based on these recommendations by the Australian Competition Tribunal in May 2001

In addition, the ENA cautions that unless the amended coverage criteria for both the imposition of price monitoring and 'reference tariff' regulation are clearly understood by all parties to *raise* the bar for coverage from the existing test, government decision-making could result in price monitoring being applied to a wider set of assets than the Commission anticipates (including those where any economic regulation is not justified).[40]

The implementation of a regulatory framework without reference to the original policy intention, and in a manner inconsistent with expectations of both the original policy makers and industry was a feature of the first six years of the regime which should be avoided in future.

[39] Productivity Commission (December 2003), p.161
[40] Draft Finding 6.8 in Productivity Commission (December 2003), p.188

Treatment of expansions

The ENA does not consider that there should be default coverage of gas network or pipeline system expansions and extensions as advocated by the ACCC and the Commission.[41]

The operation of such a presumption would undermine the principles advanced by the Commission in relation to broader coverage issues, that is, that there needs to be demonstrated and significant market power and economic efficiency benefits for the imposition of access regulation to be justified.

Default coverage of system expansions and extensions fails to recognise the different market circumstances which a system expansion or extension faces compared to the original asset configuration. The assumption that any market power that may exist in an incumbent distribution network or capacity constrained pipeline will automatically apply in relation to a contestable network extension or additional spare capacity created through system expansion is unfounded.

The ENA notes that this issue was recently treated in the Epic Energy MAPS appeal case, where the ACCC's contention that any level of potential market power justified the coverage of a system expansion was rejected by the Tribunal.[42] Instead, the Tribunal commented (using a similar analytical approach as the Commission) that in order to justify coverage of system expansions, the scope for a pipeline owner to exercise market power must be 'non-transient and non-trivial'.[43]

ENA Recommendation

The ENA recommends that the Commission:

- restrict the scope for regulatory authorities to sponsor and advocate changes to the appropriate 'tier' of pricing regulation.
- recommend that all currently regulated assets should initially operate under the less intrusive price monitoring 'tier'
- emphasise that it is the intention of the Commission for fewer gas infrastructure assets to be covered under an amended regime than are currently covered under the existing regime
- reverse the proposed presumption in favour of the regulation of gas pipeline or network system expansions

7. Access arrangements

7.1 Pricing Principles

The ENA broadly supports the proposed pricing principles for the gas access regime recommended by the Productivity Commission, with some proposed modifications.

Providing greater certainty and clarity regarding the pricing principles that underpin access pricing outcomes has the potential to play an important role in promoting ongoing investment and rebalancing access pricing regulation in the manner the Commission identified as being necessary followings the previous *Review of the National Access Regime*.

[41] Draft Recommendation 7.4 in Productivity Commission (December 2003)
[42] *Application of Epic Energy South Australia Pty Ltd* [2003] ACompT5 [109]
[43] *Application of Epic Energy South Australia Pty Ltd* [2003] ACompT5 [113]

Clearer access pricing principles for the gas access regime were a proposal widely supported by participants in the review, including by gas users, producers, infrastructure owners and regulatory authorities.[44]

Ensuring effective implementation of new pricing principles

As in the case of the introduction of an object clause, there is also a need to ensure that all parties have a common understanding and expectations regarding the impact of introducing the proposed pricing principles. The ENA considers that the introduction of the pricing principles is intended to have a material impact on future regulatory outcomes in access pricing reviews in the gas sector. This is due to the pricing principles being based on the Productivity Commission's previous recommendations in its *Review of the National Access Regime*, where the Commission identified the need for clearer regulatory guidance to rebalance access pricing outcomes and provide signals to avoid underinvestment and regulatory failure.[45]

It is vital to the successful implementation of these policy principles that regulatory authorities understand the intent and impact of the Commission's proposed recommendations. Energy network businesses remain strongly concerned that this understanding is not present, given conflicting signals from regulatory authorities. As an example, and as the Productivity Commission has itself noted, it remains unclear whether the ACCC considers that pricing principles based on those the Commission has recommended for Part IIIA of the *Trade Practices 1974* will result in an 'abrupt change' in access pricing regulation or no material change at all.[46] In circumstances where the ACCC may provide significant resources toward a future Australian energy regulator applying an amended National Gas Code, it is important that the Commission focuses on ensuring that regulatory authorities correctly understand the impact of, and have the ability to implement, changed pricing principles. For this reason, the ENA considers that the Commission should consider a broad recommendation that it is the intention of the new access pricing principles to rebalance access pricing outcomes consistent with its previous findings in the *Review of the National Access Regime.*

Modifications to the Commission's proposed principles

The ENA considers that while the pricing principles proposed for Section 8.1 of the National Gas Code are broadly appropriate, some modifications are required.

The modifications ENA members consider appropriate are the addition of:

- the words 'at least' to the proposed Section 8.1 (a) (ii) so as to require that reference tariffs should include a return on investment *at least* commensurate with the regulatory and commercial risks involved

- an explicit requirement, for the avoidance of doubt, that: 'In approving a reference tariff or reference tariff policy the relevant regulator must be satisfied that reference tariff or reference tariff policy is consistent with the objects of the Code and Section 2.24 of the Code.'

These amendments would alter the Section as detailed below (see additions in **bold**):

> *Section 8.1* The relevant regulator must have regard to the following principles when approving a reference tariff or reference tariff policy:

[44] See for example BHP Billiton *Initial Submission to the Productivity Commission*, September 2003, p.112 and Energy Markets Reform Forum *Submission to the Productivity Commission*, September 2003, p.11

[45] See for example Productivity Commission *Review of the National Access Regime - Draft Report* , March 2001, p.100 and Productivity Commission (February 2002), p.16

[46] Productivity Commission (September 2001), p.329

(a) that reference tariffs should:

(i) be set so as to generate expected revenue across a service provider's regulated services that is at least sufficient to meet the efficient long-run costs of providing access to those services

(ii) include a return on investment **at least** commensurate with the regulatory and commercial risks involved

(iii) generate revenue from each service that at least covers the directly attributable or incremental costs of providing the service.

(b) that reference tariff structures should:

(i) allow multi-part pricing and price discrimination when it aids efficiency

(ii) not allow a vertically integrated service provider to set terms and conditions that disadvantage competitors of its associated businesses in upstream or downstream markets, except to the extent that the cost of providing access to these competitors is higher.

(c) that reference tariffs should be set so as to provide incentives to reduce costs or otherwise improve productivity.

(d) in approving a reference tariff or reference tariff policy the relevant regulator must be satisfied that the reference tariff or reference tariff policy is consistent with the objects of the Code and Section 2.24 of the Code.

(f) replicating the outcomes of a competitive market.[47]

The ENA's proposed modifications to the Commission are designed to:

- emphasise that in the context of the uncertainties inherent in existing methodologies for estimating regulatory rates of return there is a need to err on the side of investors in setting appropriate regulatory rates of returns to protect against the risk of costly infrastructure underinvestment[48]

- emphasise the need to ensure regulatory authorities do not adopt a theoretical constructs based on a 'perfect competition' framework which focuses on providing returns 'just sufficient' for continued service provision.[49]

- maintain a consistent approach between sub-clauses (a) (i) to (iii) in the Commission's new proposed Section 8.1

- provide clarity that the pricing principles contained in Section 8.1 are to be interpreted in the context of the overall objectives of the regime, following uncertainty and consequential litigation on this issue under the existing National Gas Code.

The ENA considers these modifications are necessary in order to ensure the effective implementation of the Commission's proposed pricing principles.

Proposed deletion of Section 8.1 (b) 'replicating competitive markets'

The ENA notes that the Commission has proposed the deletion of Section 8.1 (b) which requires that reference tariffs be designed with a view to achieving the objective of 'replicating the outcomes of a competitive market'.[50]

[47] The issue of the retaining of this sub-clause from the original Section 8.1 is discussed in the following section 'Proposed deletion of Section 8.1 (b) 'replicating competitive markets' and is included here for illustrative purposes subject to the Commission's reconsideration of this issue – See ENA Recommendation.
[48] See Productivity Commission (March 2001), p.71
[49] Essential Services Commission *Review of Gas Access Arrangements – Draft Decision*, July 2002, p.45 see also David Round attached to Allgas submission and *Statement of Reasons - Ministerial decision on application for revocation of the Moomba-Sydney Pipeline*, para 147
[50] National Gas Code Section 8.1

Section 8.1 (b) has been subject to detailed consideration in the WA Epic Energy case, and its interpretation was core element of the judgement. As detailed in Part 5 of this submission, the ENA considers that the outcomes of the Epic Energy case reinforce and complement the broad thrust of the reforms proposed by the Commission. For that reason the ENA is not disposed to delete this clause around which much useful guidance has arisen as to how access pricing should be appropriately implemented.

The ENA seeks further clarification about the Commission's intention in removing this section and its rationale for doing so. The Commission states that it agrees with the views expressed in an opinion by an economic adviser to the ACCC to the inquiry on the utility of the concept of workable competition in setting access prices. The Commission's Draft Report does not refer at all to the sharply contradictory views of a number of other parties to the review, including an extensive opinion on the implications of workable competition for access pricing decisions developed by Professor David Round, a member of the Australian Competition Tribunal.[51]

The ENA notes that since the release of the Commission's Draft Report alone three rulings of the ACCC on matters relating to the interpretation of the gas access regime and generic competition law issues have been found to be deficient and subject to successful appeal. In this context, ENA considers that it is important that the Productivity Commission not recommend the deletion of Section 8.1 (b) unless it is certain that this will improve the quality of regulation and not have the unintended consequence of leaving regulatory authorities with less guidance from existing judicial precedents. The Commission has previously acknowledged the importance of not altering legislative criteria without being cognizant of the potential impact on judicial precedents, and ENA would be concerned if the actual unintended impact of the deletion of Section 8.1 (b) was to create greater levels of regulatory discretion than existed prior to the review.[52] The ENA considers this could have the potential to undermine the overall effectiveness of the Commission's positive recommendations.

Need for an explicit supporting section on sharing of efficiency gains

The Productivity Commission Draft Report noted the major concerns of regulated energy network businesses in relation to the sharing of efficiency gains, in particular:

- *the fact that forecast, not actual, efficiency gains are shared* – which reduces incentives and creates the risk that regulatory error could lead regulated businesses to fail to recover either efficient or actual costs

- *the lack of a balanced approach in the sharing of gains* – where businesses typically retain only 30 per cent in net present value terms of efficiency gains in excess of those forecast

- *the inconsistency between jurisdictional regulatory bodies in sharing of efficiency gains* – which leads to incentives for cost reductions or productivity improvements differing between business units within a service provider with assets across more than one jurisdiction.[53]

The Commission extensively considers the theoretical issues of symmetric and asymmetric truncation, however, for energy network businesses the resolution of the three issues identified above through specific amendments to the regime would deliver immediate and practical impetus to improvements in regulatory incentive mechanisms, and overall efficiency outcomes.

[51] See Round, D. *Workable Competition: A Modern Interpretation of the Dynamic Process of Competition*, cited in submission by Allgas Energy (submission no 69)
[52] See Productivity Commission (September 2001), p.160
[53] See Productivity Commission (December 2003), p.310

For this reason, the ENA urges the Commission to move beyond the noting of the three issues identified above and set out detailed recommendations for an additional section in the National Gas Code that:

- only permits the sharing of actual, not anticipated, efficiency gains
- requires that gains be shared at least equally (i.e. 50/50 in net present value terms) between the service provider and users over time

A specific mechanism to achieve this and drafted potential text was included the initial submission to the inquiry by the Australian Gas Association.[54]

ENA Recommendation

The ENA recommends that the Commission:

- accept the modifications proposed above to its proposed access pricing principles in Section 8.1 of the National Gas Code
- re-examine the removal of Section 8.1 (b) and confirm ENA's understanding that its removal not will reduce the importance of the implications of the Epic Energy case on the conduct of access pricing due to the incorporation of concepts of economic efficiency in the proposed objects clause for the regime
- moves to address practical concerns of energy network businesses regarding the equal sharing of actual efficiency gains through time by recommending a new section to deal specifically with the issue of the sharing of efficiency gains

7.2 Addressing the deficiencies of cost of capital model

The ENA considers that in addition to narrowing the scope for applying cost based regulation, substantial reform to the implementation of this type of access pricing regulation is also warranted.

Recognition of the need to rebalance access pricing outcomes

A key step in this regard is the need to explicitly recognise the need for a 'rebalancing' of access pricing regulation away from achieving short-term price falls for incumbent users to facilitating efficient investment and reinvestment in existing, augmented and new infrastructure, in recognition of the medium-term interests of the community in having access to a reliable and growing gas distribution network. The recent gas supply shortfall in eastern Australia as a result of a sudden supply interruption has served to dramatically highlight the high value placed on reliability and infrastructure availability by the community and has driven renewed interest from Australian governments in this area.

The Productivity Commission has previously recognised the need to rebalance access pricing outcomes and err on the side of protecting long-term investment in its *Review of the National Access Regime*. Positive recognition of the same need in relation to the gas access regime would send an important signal to governments and regulatory authorities. It is clearly warranted in the case of the gas access regime as there is strong evidence from the

[54] See AGA *Submission to the Productivity Commission Review of the Gas Access Regime*, August 2003, p.58

comprehensive survey undertaken by NECG that regulatory rates of return for Australian gas distribution networks are lower than in many comparable overseas decisions.[55]

Reducing the scope for regulatory error and reinforcing the 'propose-respond' model

In addition to recognition of the need to rebalance access prices, the ENA urges the Commission to consider the inclusion of a clarifying section in the National Gas Code to reinforce the operation of the key 'propose-respond' model set out in the Code.

The ENA would propose the inclusion into the Code of an explicit requirement that if proposed values of key market variable parameters (e.g. cost of capital parameters or demand forecasts) fall within a reasonable range then the regulator must accept a service provider's nominated value within that reasonable range in the absence of clear evidence that a fair value falls outside of such a range. The type of clear evidence that would be appropriate in applying this rule would be observed market information supported by replicable theoretical demonstration.

This type of approach is essentially a reinforcement of a current requirement of the Gas Code.[56] Making it explicit, however, may assist regulatory authorities in efficiently discharging their role under the regime in a way that minimises the risk of regulatory error. The ENA considers this clarifying amendment could be added to Section 8 of the existing Code.[57]

ENA Recommendation

The ENA recommends that the Commission:

- reinforce that a rebalancing in access pricing outcomes is necessary under the existing gas access regime
- adopt an additional clarifying amendment to make clear that regulatory authorities must accept proposed values contained in Access Arrangements which fall within a reasonable range

7.3 Detailed information requirements

Highly intrusive and costly information collection requirements have been a feature of the implementation of the existing gas access regime since 1997.

The Commission has correctly identified that the regime has imposed high levels of costs on regulated businesses, and that these costs are potentially in many circumstances not justified by any economic efficiency benefits of regulation. In these circumstances, the ENA considers that the Commission should take a highly conservative and precautionary approach to the imposition of additional regulatory information requirements.

This position is reinforced by the lack of specific evidence that increased information collection powers are required and by the lack of specification of the types of information which regulatory authorities need to collect but which they are unable to collect using existing powers. As the Commission has noted:

[55] See Network Economics Consulting Group *International comparison of WACC decisions*, September 2003, p.73-74

[56] See *Application by GasNet Australia (Operations) Pty Ltd* [2003] ACompT 6 [30]

[57] Section 8.2 (e) and Section 8.30-31 are some of the existing provisions that underpin the propose-respond model in relation to access prices, and an amendment might usefully attach to either or both of these sections.

> …the specific nature of the non-financial information required by regulators is unclear.[58]

The inability of regulatory authorities to convincingly specify the precise kinds of additional information which they require to assess reference tariffs and monitor compliance with the Code has been a key factor in the two formal decisions taken by the National Gas Pipeline Advisory Committee to reject regulator-initiated proposals for extended information-gathering powers.

The ENA considers that no further information gathering powers should be introduced into the regime without a clear demonstration (as opposed to contested claims by some regulatory authorities seeking to extend their powers) that existing powers are deficient. To date, sponsors of proposals to create additional information collection powers and costs have not been able to do this, as existing information collection powers have operated successfully in dozens of regulatory decisions. These existing information powers are constituted by:

- Section 41 of the *Gas Pipelines Access Law*
- Attachment A of the National Gas Code
- Sections 2.6-2.7 and Section 2.9 of the National Gas Code
- Sections 4.1-4.2 of the National Gas Code

The obligation is on regulatory authorities to identify precisely the types of information which they consider they cannot collect through the use of these provisions. The ENA contends that the extension of powers raised as an option by the Commission – to allow regulatory authorities new intrusive information collection powers within Access Arrangements periods – would represent an example of regulation feeding off itself.[59]

The extension of information collection powers to allow the collection of detailed information between Access Arrangement reviews would also represent a significant shift from the intention of achieving a 'light handed' regime. In circumstances where there is not even agreement amongst regulatory authorities that any deficiencies in information collection powers exist under the gas regime such an extension would involve substantial and unjustified costs to regulated businesses.[60] The ENA notes an extension of information powers under the current regime is opposed on the basis of its adverse cost impacts both by regulated businesses and significant gas producers.[61]

For these reasons the ENA considers that Draft Recommendation 7.3 (standardisation of information gathering requirements) is unlikely to be progressed and should be deferred pending regulatory bodies determining the types of information they require for the monitoring of compliance with the Code and which they currently cannot collect. The issue of harmonisation of regulatory information requirements should also be a matter considered in consultation with industry in the context of moves to establish national energy regulator.

[58] Productivity Commission (December 2003), p.246
[59] Review of *the National Access Regime – Inquiry Report*, Productivity Commission, September 2001, p. 343
[60] The Queensland Competition Authority last year moved to issue *Draft General Accounting Guidelines for Gas Distribution Network Service Providers* in reliance on Sections 4.1-4.2 of the National Gas Code, undermining claims by regulatory authorities sponsoring proposals for increased information collection powers that these provisions could not be relied upon by regulators.
[61] ExxonMobil *Submission to the Productivity Commission Review of the Gas Access Regime – Response to Draft Report*, February 2004, p.6

ENA Recommendation

The ENA recommends that the Commission:

- reject proposals sponsored by regulatory authorities to introduce new information collection powers into the regime without clear definition of the specific deficiencies of existing powers, and specification of the types of information required but currently unavailable

- reject proposals to increase regulatory intrusion and information collection within Access Arrangement periods

8. Lighter handed regulation

The ENA is supportive of the Productivity Commission's recommendations for lighter-handed regulation and considers their effective implementation has the potential to substantially reduce the risks and costs of regulation under the current regime for some networks and pipelines.

While supportive of the Commission's proposed establishment of a price monitoring option the ENA urges the Commission to continue to focus on improving the quality and reducing the cost of the 'reference tariff' tier of regulation. Depending on approaches by coverage bodies and judicial decisions, it is likely that a number of significant gas pipelines and networks could possibly be regulated under the more intensive form of regulation in the future. Improvements to minimise regulatory costs and the risk of regulatory error and failure in this area must not be neglected simply because an alternative 'price monitoring' option may exist or due to alterations in the overall level of coverage of regulation.

Similarly, as the Commission has identified, it is critically important that a price monitoring option is not applied using the methodologies and approaches that regulatory authorities have adopted under the existing cost of service based regime.[62] There is evidence that this is a genuine risk, given the ACCC's stated opposition to including a price monitoring option under the regime and its unsupported but perhaps understandable contention that the application of price monitoring would require the same level of resources as are currently provided by the Commonwealth Government under its budget allocation mechanism.[63]

Features of price monitoring

The ENA supports in principle the features of the price monitoring option proposed by the Commission.[64]

Energy network businesses consider a monitoring option with some ongoing information requirements (reduced from those in place under the existing regime), requiring separation of associated businesses, and featuring a non-discriminatory third party access policy would be a substantial enhancement to the regime. The ENA endorses the high-level focus on trend performance and reporting outcomes, rather than a focus on input costs and regulatory intervention.

The ENA does not support the NCC being given responsibility to develop information disclosure guidelines for the price monitoring option. This is due to the NCC's repeated

[62] Productivity Commission (December 2003), p.261
[63] See Productivity Commission (December 2003), p.264
[64] See Productivity Commission (December 2003), p.xliii

demonstrated preference for regulatory intervention leading to the setting of access prices under cost based forms of regulation (for example, in the case of the MSP and EGP), rather than a reliance on actual competitive forces. The ENA considers that in this context there is a substantial risk that the NCC may develop guidelines that involve a more detailed, intrusive and costly level of information collection than is actually intended by the Productivity Commission to apply under price monitoring.[65] The preliminary work undertaken by the Commission on this issue forms a more solid basis for work in this area than is likely to be developed by the NCC for some time, and ENA recommends the Commission address the issue in further detail in its final report.

As a principle of transparent and accountable regulation, ENA considers that any instruments which create binding obligations underwritten by financial penalties (as the Commission proposes in relation to information collection under a price monitoring regime), should be in the form of legislation or legislative amendments.[66] Providing for financial penalties for non-compliance with guidelines issued by a regulatory authority without a clear legislative basis for information collection obligations would be inappropriate. Similarly, any changes to the types of information required to be collected by service providers under the 'cost-based' tier should be defined through amendments to Schedule A of the National Gas Code, rather than delivered through the introduction of intrusive and open-ended information powers.

Finally, the ENA supports the recommendation for the regular publication of non-confidential data collected under a monitoring regime with any accompanying commentary restricted to matters of a factual nature only.

ENA Recommendation

The ENA recommends that the Commission:

- continue to support a less intrusive and costly price monitoring option for the regime
- should further develop a set of indicative information guidelines itself and not pass this responsibility on to the National Competition Council
- recommend that any information disclosure obligations under the price monitoring tier should be enshrined in legislation and that any amendments to existing information collection powers should be implemented through amendments to Schedule A of the National Gas Code or Section 41 of the *Gas Pipelines Access Law*

9. Investment and Access Arrangements

Promoting adequate investment in gas network and pipeline infrastructure is critical in recognising the long-term interests of the community in having access to fuel choice and competition.

It is important to emphasise, however, that ongoing reinvestment in gas infrastructure plays an equally important role in the safe, efficient and reliable delivery of gas transmission and distribution services. An approach which focuses only on the issue of investment in the context of the need to encourage new (i.e. greenfields) investment will result in sub-optimal efficiency and community outcomes.

Existing assets under the current gas access regime comprise around $8.6 billion of gas infrastructure. For the past several years new investment in transmission pipelines (which are

[65] See Productivity Commission (December 2003), p.272
[66] See Draft Finding 8.2 in Productivity Commission (December 2003), p.273

likely to substantially benefit from the Commission's recommendation in Chapter 9) has averaged around $500 million per year. Importantly, the most reliable *ex ante* indication investors and regulated businesses have at the pre-investment stage for how a new investment is likely to be treated by the regulatory framework is provided by the current treatment of existing sunk investments. When taken together, these facts mean measures to assist new investment are likely to have a limited impact on the potential for ongoing under-investment in existing assets, particularly gas distribution networks, and protecting ongoing reinvestment in existing networks is likely to be as important as special measures to protect new investment.

These points reinforce the need for the Commission to recommend approaches to regulation that go further than just removing the most harmful impacts of cost based regulation on new investments and some existing assets. The ENA has set out examples of positive recommendations that the Commission can make in relation to the treatment of existing assets under Sections 5 and 7.

Existing mechanisms and guidelines

The ENA concurs with the Commission's finding that the existing features of the access regime are insufficient to protect against the risk of deterrence of investment and medium-term underinvestment.

In particular, the ENA supports the Commission's view that non-binding draft guidelines such as the *Draft Greenfields Guideline for Natural Gas Transmission Pipelines* issued by the ACCC fail to provide adequate certainty for potential investors in long-lived gas infrastructure.[67]

Similarly, the ENA considers that the application of the existing 'incentive mechanism' provisions of the regime, and provisions to allow a limited range of regulatory parameters to be locked in for a certain period have failed to provide potential investors with appropriate treatment that would encourage further efficient investment. The possibility of using extended Access Arrangements to lower regulatory risk is also limited by the wide scope under the existing Code for regulatory authorities to require restrictive 'trigger' provisions in proposed Access Arrangements which create issues of regulatory truncation and asymmetric risk.[68]

Proposed measures to facilitate new investment

The ENA broadly supports the recommendations of the Commission on measures to facilitate new investment.

In particular, the ENA supports binding rulings on non-coverage for greenfields gas network and pipeline developments. The Commission has recommended a 15 year period for binding rulings to apply. From its understanding of commonly used project financing guidelines the ENA considers that a 20 year period of non-coverage would be more appropriate due to the potential for a 15 year period to result in significant regulatory truncation of the upside of any successful projects. The ENA considers that any period of binding non-coverage that was shorter than 15-20 years would almost certainly represent little improvement over the current regime, as the binding period of coverage would cover only the typical period of early losses experienced by greenfields developments.

The ENA would not support the concept of an unsuccessful application for a binding ruling of coverage leading to an automatic presumption of coverage under any level of the regime. The ENA supports the principle that coverage under the regime must always be initially triggered by, at minimum, a request for coverage made by a *bona fide* access seeker. In addition it is

[67] See Draft Finding 9.1 in Productivity Commission (December 2003), p.xlv
[68] See Section 3.18 and Section 8.47

important that the scope for assessment of coverage issues (and Ministerial decision-making) be consistent across the various avenues by which a new asset potentially becomes covered.

Regulatory truncation premium

The ENA supports the implementation of a regulatory truncation premium for investment in both new and existing gas infrastructure.

A regulatory truncation premium should recognise the special risks facing projects subject to access regulation. To simplify the administration of the mechanism, a set premium should be adopted (in the range of a 1.0-2.0 per cent addition to a credible cost of capital estimate).

The ENA notes that in the context of the Commission's recommendations for a price monitoring option under the regime, and a strengthened coverage test, there are likely to be a limited number of new projects that might qualify for a regulated truncation premium. Most new investments are likely to either be unregulated (through binding non-coverage rulings) or under price monitoring only. In this context, the ENA urges the Commission to recommend the regulatory truncation premium as an additional mechanism to reduce the risk and impact of regulatory truncation in the case of covered gas network system expansions or extensions.

Scope for improving competitive tender processes

The ENA considers that further recommendations to improve the competitive tender process set out in the National Gas Code are warranted.

Some of the changes ENA would propose the Commission developing in relation to the existing competitive tender process set out in Sections 3.21-3.36 are:

- scope to integrate public subsidy processes into tender processes where a policy decision is taken by government to contribute to new projects

- removal of the unbalanced requirement that the competitive tender outcome deliver the lowest sustainable tariff (Section 3.28 (f) (i)) given that other elements of a project (for example, the scope and timing of a network rollout) may be equally important and valued by potential consumers

- a general simplification and streamlining of the tender approval process set out in the provisions to recognise the marginal and contestable nature of new distribution project.

ENA Recommendation

The ENA recommends that the Commission:

- adopt the proposed 'binding coverage ruling' with the binding ruling applying for a minimum of 20 years

- adopt the proposed 'regulator truncation premium' for new and ongoing investments with a standard premium on the cost of capital of 1.0-2.0 per cent applying

10. Ring fencing and associate contracts

The ENA considers that substantial changes to the existing scope of ring-fencing and associate contract provisions under the regime are unwarranted.

The Commission's recommendation for the minor modifications to Section 7.1 of the Code to allow a 'notification only' treatment of an associate contract undertaken at the reference tariff represents a positive refinement of existing provisions that will remove unnecessary costs without impacting on the interests of any gas users. The ENA strongly supports this recommendation.[69]

The ENA urges Commission, however, to extend this treatment to other situations there is no scope for anti-competitive outcomes, specifically where (as is typical for gas networks) an associate retailer requests a negotiated service to a customer site and the service provider informs the end customer of the offer made to the retailer and advises the customer that the customer can accept the offer directly through any retailer.

Treatment of asset management contracts

The development of asset management business is an area with the potential to deliver significant benefits to the Australian economy. Extension of the scope of regulatory oversight to include examination of the costs of asset management businesses (wholly owned by a service provider) as part of the Service Provider's access arrangement review would create a significant and unjustified increase in regulatory intrusion in an area with great potential, but which will not develop without appropriate incentives.

It is critical to the evolution of competitive markets for the provision of infrastructure services that provisions are not imposed that discourage the efficient use of shared resources and/or are likely to stifle the evolution of competitive markets for the provision of infrastructure services. That would be very likely to occur if regulatory authorities were to review the costs of the affiliated asset management business as part of the Access Arrangement review, given the current state of evolution of asset management contracting and the manner in which the Code presently operates. The ENA notes that regulatory authorities already have the power to obtain information required for an Access Arrangement review pursuant to Section 41 of the *Gas Pipelines Access Law*. It is not necessary to further amend the gas access regime.

Further, the current Code provides regulatory authorities with the ability to obtain information and undertake benchmarking of the asset owners' costs (subject to the inherent imprecision of comparative data). There is no need for any further power.

The gas access regime is concerned with third party access to infrastructure, not the management or review of the method chosen by the asset owner to manage their asset. It is not necessary for a regulatory authority to have the power to approve asset management contracts in establishing tariffs payable by third parties.

Since the Commission's Draft Report the ENA notes that the Queensland Competition Authority proceeded to finalise its approval of an asset management contract between ENERGEX and Allgas which it claimed fell within the scope of Section 7 of the Code.[70] The ENA considers this a demonstrated and costly example of the misapplication of the intent of the existing associate contract provisions.

Ring fencing of asset management contractors

In response to the Commission's requests for information on requiring asset management businesses to comply with ring-fencing arrangements, the ENA notes that it is not necessary

[69] Draft Recommendation 10.1 in Productivity Commission (December 2003), p.333
[70] See <www.qca.org.au>

as any asset owner in any contract as part of its normal contractual arrangements will require the service provider to abide by the asset owners statutory obligations, including ring fencing obligations. The ENA notes also that the ACCC has stated that it has not received any complaints from users that existing ring-fencing provisions are not working.[71] In evidence to the Commission the ACCC emphasised that it considered the current provisions of the regime were working.[72] Give the broad agreement between regulated businesses and regulators such as the ACCC that this is the case, the ENA considers it is not necessary for the Commission to develop specific recommendations in this area of the regime.

Information provision and affiliated asset management businesses

The Commission has requested views on appropriate information provision arrangements for affiliated asset management businesses in Access Arrangement reviews.

The request for views appears to be predicated on a presumption that regulatory authorities undertaking price reviews have been unable to perform their duties due to a lack of availability of information from an affiliated asset management business. In fact, there is an extensive range of existing information powers under the regime. As an example, Section 41 provides regulatory authorities with the power to request information believed to be held by any person that may assist a regulator in carrying out its designated functions under the regime. This provision is not limited in application to the service provider, or asset owner.

Another reason that further information requirements being placed on affiliated asset management businesses are unnecessary and inappropriate is that the service provider has the maximum possible incentives under the existing 'propose-respond' regime to justify and explain levels of forecast or past costs. Failing to provide sufficient supporting evidence in relation to the levels of these costs has the potential to seriously damage the financial sustainability and profitability of the business concerned over the next regulatory period. Service providers undertaking an Access Arrangement review have every incentive to ensure that proposed levels of operating and capital costs are sufficiently justified by reference to good industry practice and the specific network environment.

ENA Recommendation

The ENA recommends that the Commission:

- reject proposals to extend regulatory controls and oversight on asset management contracts that were never intended to be subject to the Code's associate contract provisions
- reject the proposal for additional regulatory information collection powers in the light of existing provisions of the regime and the lack of demonstrated need for such measures

11. Administrative and appeal processes

Backdating of regulatory rulings

The ENA strongly opposes the Commission's proposal to provide regulatory discretion to backdate reference tariffs due to its unworkability and its creation of high levels of uncertainty for the service provider.

[71] ACCC *Submission to the Productivity Commission Review of the Gas Access Regime*, 15 September 2003, p.8
[72] Productivity Commission *Review of the Gas Access Regime*, Public Hearings transcript 18 September 2003, p.343-344

Backdating complex regulatory decisions on multiple classes of tariffs is potentially unworkable and inequitable. Providing regulatory authorities with the broad discretion to backdate reference tariffs could create significant uncertainty and complexity. This could arise in circumstances, for example, where a party has participated in a price review consultation process in good faith which has nonetheless taken a greater time than anticipated by the Code, the regulatory authority, and the service provider. Providing scope for discretionary decisions to impose financial penalties in these circumstances is inappropriate.

In addition to issues of equity, the numerous types of access seekers impacted by any regulatory pricing decision could make allocation of rebates a technically complex exercise potentially subject to significant ongoing disputes amongst relevant parties. Assigning rebated tariffs between a mix of access seekers and across customer types in a distribution network could be more administratively costly than the total level of rebates concerned.

Finally, backdating of regulatory determinations also has the potential to discourage the type of commercial negotiation the gas access regime was originally designed to promote. Potential users of a pipeline or network face a possible disincentive to reach separate commercial agreements on tailored terms and conditions if by reaching this agreement they potentially are made ineligible for rebates from backdated tariffs. This disincentive may reinforce the existing undesirable operation of the regime as an intrusive 'price setting' regime, rather than one that facilitates efficient commercial outcomes by providing benchmark terms and conditions to assist commercial negotiations.[73]

Proposed removal of further final decision

Removal of the further final decision would potentially remove a vital step in the Access Arrangement finalisation process that can overcome inadvertent errors in large complex access pricing decisions, as well as provide an additional opportunity to service providers to flexibly shape their Access Arrangements in ways that meet regulatory authorities stated concerns, rather than have their proposed Access Arrangements prescriptively overridden by Final Decisions.

One practical reason to maintain scope for the existing Further Final Decision is to correct errors or deficiencies that are established in the Final Decision of a regulatory authority. This is not an unusual occurrence, for example, in the most recent Final Decision on Envestra Ltd's proposed Access Arrangement for its Queensland gas distribution network, the Queensland Competition Authority made tariff calculations based on a confusion between the number of 'net' and 'gross' changes in gas distribution system connections.

This error had significant potential revenue implications for Envestra Ltd. If the further approval stages of the Code had not allowed correction of this particular error Envestra Ltd may have had restricted options to address the circumstances. These options might have included re-lodging an altered Access Arrangement to rectify the errors in the Final Decision, appeal of the decision on the grounds of a material error of fact, or acceptance of an uncertain and non-binding regulatory compact from the regulator that the resultant shortfall would be recovered in future regulatory periods. As the Code currently operates, none of these sub-optimal outcomes occurred.

A further factor for consideration is the interrelationship of the Further Final Decision and existing appeal arrangements. Were the Further Final Decision step to be removed from the regulatory process, ENA members consider that it would be necessary to review the restrictions on the scope of parties to introduce additional information in a merits review of an imposed Access Arrangement, to enable parties to be able to present to the merits review body evidence of the impact of the implementation of the Final Decision.

[73] Draft Finding 3.1 in Productivity Commission (December 2003), p.70

Appeals mechanisms under the gas access regime

The ENA fully supports the Productivity Commission's recommendations on the importance of appeal mechanisms under the gas access regime.

The removal of restrictions on the existing grounds of merit appeal has the potential to increase regulatory accountability and the quality of regulatory decision making under a reformed regime.

The Commission's findings on the importance of access to full merit appeal rights have considerable relevance and weight in the context of current discussions regarding movement towards a single national energy regulator. For this reason, the ENA considers that the Commission should make a clear finding that if a future national energy regulator assumes responsibility for administering the gas access regime, that merit appeal arrangements remain in place for the regime, and that it is clear from the overarching legislative framework that decisions by the regulator that have a potential impact on the property rights of service providers are subject to the discipline and accountability of clear merit review arrangements.

The ENA does not find arguments made by other parties through the review for the removal of appeal rights compelling. Appeals under the gas access regime involve considerable uncertainty for service providers, and for businesses which are exposed to debt and equity markets appeals are highly unlikely to be undertaken on unreasonable grounds, or for strategic or gaming purposes. This is reinforced by the fact that in the large majority of cases under the gas access regime where service providers have been forced to exercise appeal provisions, their concerns have been acknowledged by the final orders made by judicial and administrative bodies (e.g Epic Energy, GasNet, MAPS, and Duke Eastern Gas Pipeline matters). An important fact which some representations regarding the use of appeal provisions sometimes overlook are that appeals under Section 39 of the *Gas Pipelines Access Law* do not prevent a regulator drafted Access Arrangement from coming into force, hence, service providers do not have an incentive to challenge decisions merely on the basis of potentially delaying a fall in regulated revenue.

The table below (Table 1) lists some of the key appeals under the *Gas Pipelines Access Law*.

Table 1 - Summary of major regulatory appeals under the gas access regime

Appeal	Issue	Outcome
Duke Eastern Gas Pipeline appeal – May 2001	- Application of coverage criteria - Pipeline competition	Rejection of coverage decision by Minister based on NCC coverage recommendation
Epic Energy appeal – August 2002	- Setting capital base - Factors to consider in regulatory decisions - 'Workable competition'	Pipeline asset base was subsequently found be $316 million greater than was assessed under legally flawed initial decision
GasNet appeal – December 2003	- Role of the regulator - Appropriate costs to be recovered - Determining cost of capital parameters	$0.9million of self-insurance costs recognised contrary to ACCC Final Decision. Provision for pass through for counterparty defaults and terrorist risk accepted by ACCC.
Moomba-Adelaide Pipeline appeal - December 2003	- Application of existing pricing and public policy provisions - Coverage of system expansions - Requirements of Section 2.24 and Section 8.1 - Estimation of parameter values	Rejection of decision to require coverage of 25 Terajoule per day system expansion Substitution of line pipe cost of $1302 per tonne for ACCC's adopted value ($1102) for optimised replacement cost asset base valuation

Key points to consider in relation to appeals under the existing gas access regime are that:

- dozens of regulatory decisions subject to potential appeal have taken place under the gas access regime[74]

- of these decisions, there has not yet been a merit appeal sought for a pricing decision impacting on a gas distribution network

- appeals which have progressed to a decision by the Australian Competition Tribunal have in the large majority of cases led to findings that significant regulatory errors have occurred that have materially impacted on service providers' property rights

Inconsistency of appeal bodies

A point noted by the Commission but not addressed through a direct recommendation or finding is that the merit appeal bodies that deal with appeals raised by gas distribution businesses in respect of decisions on Access Arrangements vary according to jurisdiction (despite the original objective of fostering a nationally consistent gas access regime).[75] The merits appeal bodies available in relation to regulatory determinations for gas distribution networks are set out in Table 2 below.

Table 2 – Merit appeal bodies – gas distribution network decisions

Jurisdiction	Merits appeal body
Australian Capital Territory	Industry Panel[76]
New South Wales	Australian Competition Tribunal
Queensland	Queensland Gas Appeals Tribunal
South Australia	District Court
Victoria	Essential Services Commission Appeals Panel[77]
Western Australia	Western Australian Gas Review Board[78]

State legislative implementation of the gas access regime and the inconsistent patchwork of appeal bodies and provisions have resulted in divergence between arrangements relating to merits appeals:

- between regulated gas transmission and gas distribution businesses
- for service providers who own gas distribution networks or pipelines in multiple jurisdictions.

These divergences are not the result of any public policy rationale, but have emerged as unwarranted divergences that undermine the goal of a nationally consistent gas access regime which should offer consistent merit appeal arrangements and avenues across all assets regulated under the regime.

The ENA considers that it is appropriate for the Commission to make a recommendation calling for all merit review appeals to be heard by the Australian Competition Tribunal, consistent with arrangements for gas transmission pipelines.

[74] See Section 38 and Section 39 of the *Gas Pipelines Access Law* for criteria for appealable decisions. These extend beyond pricing and Access Arrangement reviews.
[75] Productivity Commission (December 2003), p.369
[76] See *Independent Competition and Regulatory Commission Act 1997*, Part 4C, Schedule 2A
[77] See Section 56 *Essential Services Commission Act 2001*
[78] See <http://www.offgar.wa.gov.au/review.cfm>

Funding arrangements for regulatory authorities

Funding and accountability arrangements for industry regulators are important matters for consideration in the final report of the *Review of the Gas Access Regime*, particularly in the light of ongoing consideration of these issues by Australian governments.

The ENA considers that due to the diffuse benefits of access pricing regulation to the community at large it is appropriate that funding for regulatory oversight is provided by direct allocation from consolidated revenues. The cost of administering access pricing regulation is incurred solely due to the benefits derived by the community as a whole, as no benefits are derived by the service provider through the negative impact of access regulation on the exercise of its private property rights.

In the undesirable circumstances where some form of levy is imposed on regulated businesses to support the operation of a regulatory body, several design features become important. First, it is critical to avoid the perverse incentives that are potentially created in having the costs of legal actions undertaken by the regulator funded through cost-recovery arrangements. This effectively leads to circumstances which a regulatory body faces no incentives to minimise the total level or scope of litigation undertaken. Second, there is a need to allow the passing through of any cost-recovery levy placed on service providers to end users, given that a mandatory regulatory levy imposed on a service provider is by definition an unavoidable operating cost for the service provider.

ENA Recommendation

The ENA recommends that the Commission:

- review the workability and equity of proposals to allow the backdating of regulatory pricing decisions
- reconsider the removal of the valuable 'Further Final Decision' stage in Access Arrangement approvals
- reaffirm that merits review appeals arrangements in all jurisdictions should be consistent and should nominate the Australian Competition Tribunal as the responsible body for administrative review of decisions
- recommend that where levies are imposed on regulated entities to recover the cost of regulatory oversight, there must be provisions for these costs to be passed in full through to the beneficiaries of access regulation, end users

12. Institutional arrangements

The ENA supports the concept of a single national energy regulator provided the regulatory framework provided by the gas access regime is improved at the same time consistent with the directions of the Draft Report and ENA's suggested modifications. An additional condition is that the decisions of the single regulator need to be accountable through the types of merit and judicial appeal arrangements supported by the Commission.[79]

[79] Productivity Commission (December 2003), p.360

Separation of coverage determination and regulatory functions

The ENA fully endorses the views of the Commission that there must be separate agencies to make decisions on what type of regulation is required (including no regulation) and to implement and administer the type of regulation deemed appropriate.

The ENA strongly supports the retaining of Ministerial involvement in pipeline coverage issues, particularly given the Commission's recommendations would retain an explicit 'public interest' assessment criteria in the coverage test. Where significant judgments on the range of possible public interest factors are required, the ENA considers that Ministerial involvement is most appropriate. Participation of Ministers in coverage determinations also has the potential to improve the quality of coverage decisions by allowing a broader view of competitive developments in relevant markets to be incorporated into coverage decisions, as has been demonstrated in the decision to revoke coverage over significant elements of the Moomba-Sydney Pipeline system following the revocation of coverage of the Eastern Gas Pipeline.

Code change arrangements

The Commission has noted that the existing Code change arrangements are not effective, and may be subject to review by Australian governments responding to the recent Energy Market Review.

The ENA concurs with this view, however, it considers that the detailed consideration which the Commission has given to the issues should enable the Commission to make some indicative recommendations on what would constitute a workable model for improved Code change processes.

Two core issues in the existing Code change mechanism which require addressing are the:

- inappropriate participation of regulatory authorities in the initiation of, and decision-making in relation to, proposed amendments to the Code
- inadequate opportunities for formal participation by the owners of sunk capital investments impacted by the regime in National Gas Code amendment procedures and processes

The ENA considers these issues can be usefully and practically addressed by the Commission by the formulation of specific recommendations.

ENA Recommendation

The ENA recommends that the Commission:

- maintain its recommendation that separate bodies should assess coverage under the regime and apply the regime
- make a final recommendation that representatives of regulated service providers should be provided with a formal vote on proposed amendments to the gas access regime
- incorporate into its final recommendations the principle that the ability to initiate Code change should be limited to representatives of regulated service providers, policy agencies of Federal, State and Territory governments and representatives of gas market participants.

The Energy Networks Association
5 March 2004