Productivity Commission Inquiry
Review of the Gas Access Regime

Submission

In a scene from the movie *The Matrix* (1999), Neo, the saviour of humanity, goes to meet a fortune-teller to confirm his status as "the one". As he enters the room, The Oracle says "don't worry about the vase". Neo flinches. In doing so, he knocks the vase to the floor and it breaks.

The exchange highlights our interrelatedness and the circularity that comes with asking counterfactual "what ifs". As The Oracle suggests after the incident: "What's really going to bake your noodle later on is would you still have broken it if I hadn't said anything".

The regulation of infrastructure, including gas assets, endures a similar set of circumstances. In essence, the ultimate objective of regulation is to be benign. This is a vexing task, however, as the quest for greater efficiency is essentially an ever-present "vase-like" question for which there is no literal answer.

The nature of an alternative world without access regulation can only ever be a concept; an open question, like Neo's pondering of whether or not the "accident" would have occurred under different circumstances. The regulatory agent is an inexorable part of the adaptive system it wishes to second-guess.

The only possible way to assess the performance of others is to therefore become "nothing". But of course the prospect of a regulator adopting such a creed – I existence only in order to not exist – is unlikely. Apart from the violent contradiction, a statement such as this, while intuitively appealing, would be seen to send the wrong message to those being regulated. We thus end up with a situation where-in the regulator exists to be benign but cannot state as much for fear that it will jeopardise its *raison d'être*.

Background

The Commission has been asked to improve the access regime for gas. I would like to explore a novel approach to addressing the apparent conflict.

Rather than argue over what is or is not optimal, why not ask why there is an argument in the first place? Surely, the ultimate objective (if not expectation) of policy should be to find common ground? On this basis, could it be that the vase question, while initially of value in terms of improving efficiency, has now become a burden due to its potentially circular nature? And if this were the case, what risk that our self-absorbed questioning has meant we have missed seeing the loop?

While the process of micro-economic reform has delivered much in the way of increased economic wealth for the nation, third party access and competition-based initiatives are becoming increasingly clichéd and laborious. The reforms have yet to achieve a shared sense of conclusiveness – both here and overseas. There is no sense of resolution, with a multitude of jurisdictional access regimes and a growing width and depth of regulation despite a founding belief in light-handed intervention. In addition, operational and financial difficulties continue to beset infrastructure owners, particularly in the electricity and rail sectors.

A new perspective is needed. I believe that this will only come when we re-examine the theoretical foundations of our current policy paradigm and, in particular, the potential for paradox. The following discussion is designed to stimulate such considerations as a means of improving the gas access regime in Australia.

Foundation Theory

Contradictions pervade the regulatory regime for infrastructure. In the Draft Report (p. 77), the Commission states that:

> Regulation should be introduced only if it leads to a better outcome than that which would occur in its absence, after accounting for the costs of implementing the regulation. From the community's perspective, an efficient market produces the best outcome where total welfare is maximised.

Elsewhere, the Commission (p. xxv), suggests that:

> [q]uantifying the benefits and costs of the regime is extremely difficult, particularly in the absence of information about what would have occurred without the regime (the counterfactual). This is even more difficult because … there are other dynamic competitive forces at work as competition emerges; and other policy influences are at work.

The key issue of the efficacy of regulation has been left hanging. Can we really understand the counterfactual? The implied answer(s) seems to be: yes and no – and, possibly, both. We revert to phases such as "extremely difficult", while at other times it is impossible. We wish to promote efficiency in order to create wealth, but cannot agree on what this "better" – albeit unreal – world looks like.

The economic paradigm that dominates Australian policy development is founded on the free market principles articulated by Adam Smith in the 18th century. The ideas espoused by Smith are riddled with potential contradictions and dilemmas. For example, he believed that the force of self-interest was the chief source of wealth creation. His famous passage in Wealth of Nations states:[1]

> Every individual … generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intension.

At the same time, Smith was adamant that progress must also serve the greater good: "No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable".[2] Significantly, Smith therefore believed that the broader benefits of a free market were an unintended consequence of allowing self interest to reign free, while at the same time acknowledging society's desire to advance collectively. His observations present a set of paradoxical conclusions:

- Without self-interest, the individual has no incentive to seek out opportunities to trade and specialise;

[1] Smith, A. (1776), *An Inquiry into the Nature and Causes of The Wealth of Nations*, Chapter II, Book IV.
[2] Smith, A. (1759) *The Theory of Moral Sentiments*, Section III, Chapter III, Part II.

- To be successful, however, the self-interested individual must make the customer the most important aspect of commerce; and

- A consequence of this process is that the whole community benefits.

Thus, we are left with the contradictory statement that allowing the individual to be utterly self interested means that the consumer becomes "sovereign" and, in the process, the wider community is made better off. National wealth is not an objective *per se* – it is a natural outcome of allowing the invisible hand the freedom it requires.

On this basis, the *laissez faire* philosophy of the free market is difficult to define in a broader public policy sense. Efficiency is quintessentially poetic: less means more. It is about taking away rather than adding. As such, the free market is not a "thing". Our best attempt at a definition must be framed in a negative way: it is that which prevails when impediments and the "dead hand" of government and bureaucracy are removed. The market is therefore literally "nothing" – yet we favour it because we believe it to be anything but. I suspect this is why Smith had to revert to a metaphor to evoke the positive attributes of the market.

The difficulties in adequately defining efficiency carry over to attempts to measure it. As noted by Queensland Rail, its elusive nature is actually the key reason why governments have embraced economic reform and withdrawn from directly determining prices, quantities and the make-up of goods and services provided to the community.[3]

> Ironically, however, this efficiency goal cannot be objectively quantified. While the concept of a perfectly free market is said to produce efficient outcomes, true efficiency is encapsulated in the process that takes place between the parties. Elements of efficiency can be observed before and after the event, but its essence is <u>within</u> the relationship.
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> This dynamic aspect of efficiency is the very reason why Australia has moved away from government intervention and inefficient regulation. If the government could capture efficiency then it could be set to work in a formal mechanism that then created the optimal economy for a society. The implementation of market-based policies reflects a threshold commitment to a belief that this cannot be done.

Policy Objectives

The preceding discussion establishes the following paradox: the free market philosophy has been adopted because it promotes prosperity, yet prosperity is not its formal goal.

Policies designed to promote market-based outcomes (eg access regulation) can therefore be seen as <u>both</u> a means (to a wealth creation end) and an end.[4] Efficiency is an end in itself because the spin-off benefits are a consequence, not an objective. The self interest-public interest (or "disinterested") paradox is confounding

[3] Queensland Rail (2003), "Towards an Effective Access Regime", Submission to Australian Logistics Council, August (see <u>www.qr.com.au</u>).

[4] Both views can be found in the Commission's draft report. The desire for an overarching objects clause is about recognition that all regulation should, ultimately, be about a higher (and common) objective which is implied in the outcome of economic efficiency. On the other hand, the Commission lends support to the view that individual commercial interests should be the focus. This is implicit in the Commission's aversion to a "public interest" clause in the Gas Code.

as it blends the open-ended process of freedom (ie removing barriers and constraints to allow self interests to prevail) with the fixed goal of a happy, prosperous society for all.

This paradox has typically been dealt with by trying to strike a balance between the interests of the self and the public.[5] They are treated as conflicting goals, set against each other in a policy framework.

Because we fear the consequences of absolute freedom, we actively work against the objective of allowing self interest to thrive.[6] At the same time, however, we set about promoting it. Policies such as privatisation, corporatisation and deregulation are all designed to create new incentives to promote efficient resource use. But while government has set the entrepreneurial spirit free on the one hand, it has also burdened business with various controls and regulation which seek to keep self interest in check.

Good intentions aside, it is vital to acknowledge that our access regimes are built upon a fear of exploitation and dishonesty. While this approach may serve up to a point, it is subject to diminishing marginal gains. Assuming the worse may have been necessary to drive out residual inefficiencies within public sector monopolies, but such assumptions are hardly conducive to motivating business to seek out opportunities that will ultimately benefit the broader community.

The ambiguity resulting from the disinterested paradox is an inescapable source of conflict that distracts us from actually realising the right balance between the interests of the self and the public. Ironically, this conflict can only be overcome if we "ignore" the need for such a balance. Making the right balance a goal must eventually burden the sense of freedom that is necessary for attaining it.[7]

An overarching "objective" for infrastructure regulation cannot therefore be an objective as such. Rather, an objects clause should look to express the paradoxical nature of regulation, insofar as it is concerned with both the absolute process of allowing self interests to thrive and the goal of promoting public interest. The contradictions implied with such should be made explicit.

- *Process* – If self interest is constrained in <u>any</u> way, the incentives necessary for wealth creation will be limited and thus efficiency can never be maximised. By definition, self interest can only ever flourish if free of obligation, including, most importantly, the need to do something in the "public interest".

- *Goal* – At the same time, however, it is understood and accepted that allowing self interest free reign can only ever ultimately be a means to an end. While this may be achieved on an individual level, this goal is improved welfare for the wider community. It is given that the individual is only truly efficient (ie "happy") if and when it is part of the whole.

Shared Purpose

As noted above, the current policy paradigm deals with the disinterested paradox by setting the respective interests up against each other in a standard opportunity cost

[5] The self can be taken to be anything less than the whole, such as an individual, corporation or a nation.
[6] Note the contradiction in this belief: freedom is a process which is an end in itself and thus should have no direct regard for consequences – such consciousness would conflict with the process.
[7] It is interesting to note that Mark Latham, Leader of the Opposition, recently stated in a speech to the National Press Club that the balance between family and work "is a process, not a destination".

based policy framework. Shareholder value for an infrastructure owner is traded-off against the needs of users and their customers. This same approach is used in a broader policy sense to balance material wealth against "social" goals, such as equity and preservation of the natural environment.

A policy-based "battle" between different interests can never deliver a sustainable equilibrium – only moments of perceived poise between the endless cycles of imbalance. After an initial period of development and application, it is fair to say that the regulatory focus for infrastructure access, including gas, has begun to shift away from a public interest objective (implied or otherwise) to a greater recognition of the primacy of self/commercial interests. This was noted in the OECD quote cited in the draft report (p. 154):[8]

> The gradual shift away from use of competition laws in OECD countries to promote public interest objectives suggests that a consensus may be emerging that it is suboptimal, at least once a country has reached a certain level of development, to use competition law and policy to promote such goals.

While confrontation has served us well up to a point, it has serious limitations. A dialectic approach based on opposing views tends to promote the separation of interests and the "taking of sides". As a situation becomes more tense, these demarcations become more profound.

The right regulatory balance between shareholder value and community welfare must be found through alignment of a shared purpose. This comes via acceptance of the disinterested paradox, as it incorporates both the process of freedom and a goal beyond self interest.

The most important ingredient in a regulatory regime, however, is the presence of individuals who are willing to live the disinterested paradox. Not to talk it. Not just to write it down as a mission, throw some money at the community or to have it legislated. But to <u>be</u> it by asking oneself what is of ultimate value.

In this regard, it is obviously essential that an individual have the means to support themselves and their dependents. It is also clearly important that an organisation make profits and sustain itself – it cannot add value to the community through job creation and development, if it is bankrupt. In terms of the gas regime, it is therefore necessary that an infrastructure owner receive a fair rate of return on regulated assets.

That said, there is a wider context for all this which must always recalled: self interest is necessary but not sufficient – it can't be <u>that</u> important. Is commercial life really about worrying and arguing over half a per cent of a WACC calculation, or is it about getting gas out of the ground and delivering it to industry and consumers to make for a more prosperous and vibrant community?

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[8] This has also been implicitly recognised by the Commission and others in recent discussions concerning access. The Commission has lent support for a truncation premium for infrastructure owners and suggested that regulators should not become over-anxious about getting it "right" when it comes to driving out monopoly-based inefficiencies. In a more philosophical sense, the comments by NECG to the Commission's National Access Regime Inquiry are instructive: "[A]n unregulated monopolist need not be technically inefficient. While complex arguments can be mounted as to why a monopolist might be less efficient in a static productive efficiency sense than a competitive firm, powerful counter-arguments can be put pointing the other way. Nor is there any *a priori* reason to believe that a firm exposed to competition will innovate at a more socially efficient rate than one that is not so exposed." This shift is also manifest in the change of chairmanship at the ACCC.

More importantly, does believing as much render self interested pursuits trivial?

Acceptance of the paradox provides a basis to transcend the conflict typically found in a regulatory regime. A belief that making broader community interests the most important objective does not mean that an individual or corporation should forfeit their own interests. However, it does provide a common reference point for a shared purpose and thus sustainable efficiency – different, individually-motivated parts going to making an efficient whole.

An effective regulatory regime would therefore promote this higher shared purpose and sense that, ultimately, there are no sides – just a network that must operate in harmony if it is to make a contribution that matters.

Ironically, this can only progress on an individual basis. It cannot be promoted collectively – an inclination to want or need others to do likewise, implies some form of conditionality which will limit the positive forces of our self-interestness.

Acceptance of the disinterested paradox is a “leap of faith”.

Paradox within a Paradox

While access regimes in Australia were developed according to the principle of light-handedness, we continue to struggle with the crowding out effect of regulation. It is as if we cannot avoid it even after acknowledging it is something we wish to avoid. This is because the trap presented by the disinterested paradox is itself subject to a more profound trap.

If the initial paradox is real, then it follows that the more rational we tend to become, the less likely we will be to “believe” it. A paradox is defined as something that does not make sense to the mind. It should therefore not be surprising that, as we become more intellectual, we will be less able to retain the notion that paradoxes cannot be understood intellectually.

While this irony may be identified and even accepted at some point in time, it will tend to be forgotten, as we are predisposed to resorting to our minds in an effort to understand why this is so. That is to say, even though we may accept that there is no formula or literal representation of efficiency, we are fated to discount metaphoric and allegoric representations (eg invisible hand) and continue to search for a “something” that can be understood and thus amendable to quantification and manipulation.[9]

It is not the paradox *per se* that bakes our noodle: it is our need to ask the question and thus become confounded by its impenetrable nature. A paradox only becomes such, if we opt to think about it.

Conclusion

In *The Matrix*, Neo has a mentor, Morpheus. After realising that he has failed to perceive his reality, Morpheus offers the confused Neo the following advice: “Faith is a not a matter of reasonability. I do not believe things with my mind. I believe them with my heart – in my gut”.

[9] This condition (Louise’s Dilemma) is discussed in a more comprehensive manner in the *in tempore* Advisory submission to the Commission’s recent Housing Inquiry.

Australia embraced market-based reforms because of a "gut feel". There is no way to prove the merit of the free market philosophy which underpins initiatives such as National Competition Policy and third party access. This ineffability – the invisible hand – is its defining aspect. It recognises that infrastructure is a dynamic system, the management of which is more an art than a science. As such, a situation where parties are arguing over what is efficient and what is not, is evidence that we have missed something of greater significance.

The economic leap of faith practiced in the late-1980s and early-1990s has been a double-edged sword. It provided the zeal necessary to set in motion a policy agenda that has potentially secured Australia's economic future. But it also glossed over the contradictions that are buried within the underlying "theory". For example, policies designed to promote market-based outcomes can be seen as both a means and an end in themselves. Likewise, the free market is said to be efficient, yet there is no way of objectively quantifying what this means.

While the gains were easy, these paradoxes caused us little grief. They are now placing major stresses and strains on, amongst other things, access regimes. As a result, the process is becoming about catering to the interests of separate groups (eg owners and users, corporations and the wider community), rather than promoting the bigger picture, as intended.

A regulatory battle will not achieve the efficiency we seek, as our ultimate and most sought-after needs are shared, beyond quantification and not amenable to our traditional opportunity cost based policy framework.

Despite this, we continue on with a two-dimensional approach in the hope that driving it harder may yield further benefits. In the process, our growing rationality makes it more-and-more difficult to acknowledge the presence of the contradictory win-win scenario that first attracted us to Smith's postulations and why we welcomed the free market philosophy.

If the initial gains of the gas access regime are to be capitalised on and a sustainable balance between various interests discovered, the paradoxes within economic theory must be made explicit and integrated into the regulatory regime. This will provide the foundation for the individuals that work within the regime to personally align their self-interests with those of the broader community and thus promote a change that instils a true humanity into our commercial and regulatory interfaces. As noted by the former head of the National Competition Council:[10]

> A focus on human welfare is critical to any future reform program and could benefit from improved change management. Why? Because it puts human beings at the core. It demands constant reference back to the only reason these changes were introduced in the first place, and that is for the good of the Australian community as a whole.

It is time we started living the free market philosophy through its paradoxes, rather than just espousing its rhetoric. As Morpheus tells us, there is a "difference between knowing a path and walking a path".

[10] Samuel, G. (2003), "A Changing Australia: The Business and Social Imperatives – Keeping Reform on Track", UNSW Australia Graduate School of Management Alumni Meeting, 26 February, Canberra (see www.ncc.gov.au)