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IPA Response to the Productivity Commission's Draft Review of the Gas Access Regime

The Commission's Analytical Approach

IPA is much impressed by the quality of analysis and the conclusions drawn by the Productivity Commission in its Review of the Gas Access Regime.

We regard this analysis as further assisting the improved understanding of the arrangements necessary to ensure a competitive, low cost supply industry driven by the need profitably to meet consumer needs. In this respect, the draft report builds on the excellent work conducted by the PC in its Part IIIA inquiry and on the Energy Market Review (Parer Committee).

IPA's misgivings are about the translation of this analysis into policies some of which may not give effect to the diminished regulatory load that the PC clearly sees as being necessary. We consider it would be helpful if the Commission offered increased detail spelling out the meaning of its recommendations in order to offer unambiguous guidance to those responsible for formulating and administering the policies it recommends.

Comments on the Draft Review's Recommendations

The Objects Clause

The Draft report recommends an "objects" clause and provides one in recommendation 5.1. That recommendation is:

To promote the economically efficient use of, and investment in, the services of transmission pipelines and distribution networks, thereby promoting competition in upstream and downstream markets

This is supported by the sections preceding it and following it in the draft report. The words have a clear meaning to economists who subscribe to free market principles and who are skeptical about whether government regulation can improve on market outcomes

except in very special circumstances. Those circumstances revolve around monopoly and even then government intervention is acknowledged as not necessarily efficiency enhancing.

Others however are not so wedded to this philosophy and see "market failures" that demand regulatory intervention at a great many junctures. Such lack of confidence in market forces has proven to be highly prevalent among the regulatory agencies like the ACCC and NCC which will be required to interpret the clause.

In this respect, the Draft report points out that the ACCC, for example in its Greenfields Guideline, and the NCC in its decisions on the pipelines from Moomba and Bass Strait to Sydney set the bar far higher than is implied as being necessary and efficient in the PC Draft report. The hearings transcripts, particularly of the evidence provided by the ACCC, seem to show a far greater faith in regulatory efficiency than is shared by the industry or the PC. Of course, it might be argued that the regulatory agencies have a vested interest in emphasizing the need for their services but this does not detract from the damage that they could do if that power is in fact used abusively.

This is pertinent because many would take a different view of the words the Draft offers to that which you would prefer. For example, **"economically efficient use of"** might mean ensuring that its use is maximized as long as marginal costs are covered. Some submissions clearly take this as a starting point for efficiency. Of course, if a business were obliged to price its goods at marginal cost and it was on a diminishing cost supply curve, it would not cover overall costs and the facility would not be built in the first place. Once built, such a facility would be hostage to regulatory expropriation and investors would avoid the investment.

Again the phrase, **"thereby promoting competition in upstream and downstream markets"** might have some negative outcomes. The would-be owner of a facility is unlikely to have such goals in mind, indeed the owner would wish to squeeze out all possible value from his investment. The pursuit of "economic rent" is a major motive for investment and this may not be achieved by promoting competition. It is, of course, a major goal of government to ensure competition is in place (though not necessarily maximized) in order for efficient outcomes to emerge. But this may entail, indeed is likely to entail, super profits where an entrepreneur spots an opportunity to meet consumer needs.

The goal of government is not to pre-empt behaviour that seeks to exploit such situations but to ensure that open markets prevail so that new providers are not prevented from entering markets that have proven to be profitable. This does not mean requiring a firm that has developed a facility to carry all such providers. To do so may undermine the contractual basis for the facility to be built in the first place.

In recognizing these points, the Draft draws attention to the damage inherent in truncated regulatory decisions that lop off the scope for high returns, and the dangers of outcomes that are "fit for purpose" pipelines designed to prevent the capability of carriage

additional to that of the foundation contracts. Others may not be so aware of the interconnectedness that the PC carefully documents especially in Chapter 4 of the Draft.

The recommendations that follow Draft Recommendation 5.1 also add little clarity to decision makers. However, requiring that **coverage of the pipeline is likely to improve economic efficiency significantly** (Draft Recommendation 6.4) might help in avoiding the sort of catch-all decisions that brought all existing pipelines under the coverage net in the first place.

The Commission seeks to limit the scope for unnecessary regulatory intrusion by substituting ***material*** for ***substantial*** in specifying when the authorities might legitimately seek coverage. It is not clear that the difference in the definition of those words would have the desired effect.

Reference Tariffs

The Commission quite appropriately seeks to establish a case for regulated tariffs to be set at a level which meets long run efficient costs.

Monitoring

In line with its commendable preference for lighter handed regulation, the PC argues for a monitoring system (Draft Recommendation 8.3). In some respects, the ramifications of this might, if not handled carefully, backfire on the sort of increased investor certainty that the PC rightly considers to be necessary. Thus Draft Recommendation 9.1 seems to weaken the automatic nature of the access holiday for Greenfield sites implicit in Parer. Arguably, it opens a window for a five year review. It also, in arguing that rulings, **"should not be revoked unless the information is proven to be false …"** adds another source of uncertainty to an investor. All information some years on is likely to prove to be false and this offers an interventionally inclined regulator an opportunity to re-open a case.

Some Suggestions on How to Improve the Recommendations

Regulatory Disengagement for Greenfield Pipelines

IPA views are anchored on the notions that efficiency is best achieved if property rights are clear and if the rights holders have minimal impediments to their peaceful use of the assets they represent. As with other assets through the ages, an initial monopoly created by an entrepreneur cannot be held indefinitely and the pursuit of sound government makes a compromise between opening it up to access (or placing it in the public domain) and offering the entrepreneur sufficient incentive to obtain rewards from the innovatory action or discovery.

A 15 year period is one arbitrary cut-off point. Though it is less that the patent period (and considerably less than the copyright period), we are of the view that 15 years or some other similar period be unambiguously endorsed as the regulation free period for Greenfield projects. These should include step-outs of existing pipelines where the

expansion is open to others to have provided it. .

Regulatory Control over Other Pipelines

The Australian pipeline system is presently a dual structure comprising pipelines built under conditions of guaranteed monopoly and pipelines built without any protection from competition. The latter should not be subject to regulatory oversight at least during the "regulatory holiday" period.

With regard to the former, regulation can be relaxed once workable competition is in place. This is whenever more than one pipeline competes or if the pipeline is relatively unimportant/is fully integrated with the supplier or is fully contracted in some other way. Pipelines that were once monopolies are seeing that market power reduced in the cases of the pipelines supplying Adelaide and Sydney. The linkages to the Victorian system also offer the prospect of a lighter regulatory regime.

We consider the community would be well served by the PC establishing a tighter set of regulatory recommendations that give expression to this.

Market Carriage in Victoria

The Commission deferred judgments on the issue of Victoria's unique market carriage system. IPA has been critical of this since we feel it is intrinsically inefficient because the rights of the property owner are controlled by a not-for-profit government agency which cannot have the same interest in maximizing the output from the capital as a conventional owner.

Vencorp, which controls the Victorian network, claims its system is efficient. The IPA position on this follows from our general approach that only when property rights are clear and known will the various parties have incentives to operate efficiently. Even the best resourced and most capable agency, and we have considerable respect for Vencorp, cannot make such a system work efficiently.

We remain of the view that the Victorian market carriage system should be converted to contract carriage and the various parties would then have both supply and transport contracts that would allow value to be derived from trading while GasNet would receive incentives to find new capacity and, as a shareholder owned entity, incentives to offer contracts that can guarantee supply.

Implementation

With the delivery of the final report of this inquiry three recent reports on the broad issues it covers will have been submitted to the government. While these three reports have been important in illuminating the matters covering gas infrastructure, it is even more important to ensure that their recommendations are formally incorporated into the regulatory arrangements.

The Reference does invite the Commission to consider the Part IIIA and Parer recommendations as well as court and other responses to the Eastern Gas and Dampier to Bunbury in framing its recommendations. To give effect to this, the Commission might give consideration to making some more specific recommendations alongside the findings it makes under **Institutional Arrangements**.

Alan Moran
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