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29 August 2003

Gas Access Regime Inquiry  
Productivity Commission  
LB2 Collins Street East  
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Dear Inquiry Team

**Submission to the Review on Gas Access Regime**

KPMG welcomes the Productivity Commission's Review of the Gas Access Regime.

Our involvement as advisors to the Australian energy sector has given us an insight into the practical implications of the choices made by Regulators in implementing the Gas Access Regime.

In our opinion the Gas Access Regime is not working effectively and has not served the interests of Service Providers, Users, Prospective Users, or the public interest.

Please contact either me on (03) 9288 5080 or Dr Sylvia Chan on (03) 9288 6156 if you have any questions arising from this Submission.

Yours faithfully

Graham Holdaway  
*Partner*



kpmg

Submission to the  
Productivity Commission's  
Issues Paper on its  
Review of the Gas Access Regime

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*This report contains 1 pages*

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## Contents

<b><u>1</u></b>	<b><u>SUMMARY OF OUR SUBMISSION</u></b> .....	<b>1</b>
<b><u>2</u></b>	<b><u>INTRODUCTION</u></b> .....	<b>4</b>
2.1	<u>OUR INTEREST IN THE INDUSTRY</u> .....	4
2.2	<u>THE FOCUS OF THIS SUBMISSION</u> .....	5
<b><u>3</u></b>	<b><u>“WORKABLE COMPETITION”, OR COMPETITION IN REAL MARKETS</u></b> .....	<b>10</b>
3.1	<u>THE EPIC DECISION</u> .....	10
3.2	<u>THE CONTEXT: SECTION 8 VERSUS SECTION 2.24 OF THE CODE</u> .....	10
3.3	<u>ROLE OF THE REGULATOR: BALANCING INTERESTS</u> .....	11
3.4	<u>PROMOTING COMPETITION: COMPETITION IN REAL MARKETS</u> .....	12
3.5	<u>PROMOTING COMPETITION: A NOTE ON “NATURAL MONOPOLY” AND MONOPOLISTIC BEHAVIOUR</u> .....	13
3.6	<u>PROMOTING COMPETITION: THE MARKETS AND DRIVERS OF COMPETITION IN TRANSMISSION VERSUS DISTRIBUTION MARKETS</u> .....	15
<b><u>4</u></b>	<b><u>THE ROLE OF THE REGULATOR IN VALUING INVESTMENT</u></b> .....	<b>18</b>
4.1	<u>THE REVIEW OF THE NATIONAL ACCESS REGIME</u> .....	18
4.2	<u>THE NEED TO LOOK AFTER LONG-TERM, DELAYED COSTS</u> .....	19
4.3	<u>THE RISK OF OVER-INVESTMENT UNBUNDLED</u> .....	19
4.4	<u>UNDERSTANDING THE “INVESTMENT DECISION”</u> .....	20
4.5	<u>THE IMPORTANCE OF PREDICTABILITY AND INVESTOR EXPECTATION</u> .....	21
4.6	<u>A FINAL NOTE ON REGULATORS’ “DISCRETION” AND POWER</u> .....	22
<b><u>5</u></b>	<b><u>SOME CONCLUDING THOUGHTS</u></b> .....	<b>24</b>
5.1	<u>WHAT NOW?</u> .....	24

# 1 Summary of our submission

KPMG is pleased that the Productivity Commission (“the PC”) is reviewing the operation of the Gas Access Regime<sup>1</sup> (“the Regime”).

Our involvement as advisers to the Australian energy sector has given us an insight into the practical implications of the choices made by Regulators in exercising discretion afforded to them pursuant to provisions of the Gas Code.

We have also been in a position to observe the responses of infrastructure owners to the incentives that regulatory behaviour has created.

In our opinion, the Gas Access Regime is not working effectively.

Our experience indicates that regulators have exercised their discretion in ways that have, on balance, not been in the interests of Service Providers, Users, Prospective Users and the public interest, including the public interest in having competition in markets.

In our view, the Productivity Commission’s 2001 Review of the National Access Regime<sup>2</sup> and the CoAG Energy Market Review<sup>3</sup> (“the EMR”) identified the “regulatory implementation problem” and provided a clear rationale for change – substantially within the current legislative and regulatory framework. The conclusions drawn in those Reviews are particularly relevant to the gas industry.

The August 2002 decision of the Supreme Court of Western Australia<sup>4</sup> (“the Epic decision”) confirmed that the approach adopted by the Regulator to the Access Arrangement proposed for the Dampier to Bunbury Natural Gas Pipeline did not meet the requirements of the Gas Code<sup>5</sup> - again a problem of regulatory implementation.

We think that the Current Regulatory Paradigm fails because those who have created it – the regulators – have valued abstract, economic constructs over the practical (if messy) realities of the real world markets it is supposed to serve.

It has focused on the minutiae at the expense of the broader and more important issues of why regulate to promote competition, of promoting investment so that competition can actually happen, and of the long-term as against the short-term interest of the public.

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<sup>1</sup> National Third Party Access Regime for Natural Gas Pipelines.

<sup>2</sup> Productivity Commission, Review of the National Access Regime: Inquiry Report, 28 September 2001.

<sup>3</sup> Council of Australian Governments, Towards a Truly National and Efficient Energy Market, report of the Energy Market Review, 2002.

<sup>4</sup> Re Dr Ken Michael AM: ex parte Epic Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231

<sup>5</sup> The approach used by the Regulator in this case was consistent with that applied by other Regulators elsewhere in Australia to other energy infrastructure.

We do not agree with the frequent contention that there are not viable alternative regulatory approaches to those currently adopted:

- It is open to Regulators to reject benchmarks and economic constructs derived from the theory of perfectly competitive markets, but be led by the concept of “workable” or effective competition; and
- It is open to Regulators to value the reality and early availability of new infrastructure more highly than theoretical (or even actual) risks of over compensation or inefficient investment. Some guidance from governments about the priority of this objective would be helpful for Regulators in exercising their discretion.

Our work with infrastructure investors gives us an understanding of how investors are responding to the administration of the Regime.

The expectations of investors in the mid 1990s as to how Australian access regulation would work were not subsequently borne out. We believe there were two components of this result.

Firstly there was clearly a degree of “irrational exuberance” on the part of some investors. The consequences of this exuberance have now been borne by those investors.

The second element of the result was a general expectation that Australian access regulation would give greater weight to Service Provider interests and be generally more “light handed” in nature than has turned out to be the case. We think the substantial costs of this element are being shared – between investors (in the short term) and the public (in the medium and longer term).

We observe four trends in the responses of the industry:

- There has been a significant amount of litigation;
- Investors are changing their risk allocation, shifting risk out of the sector onto other parties to the extent they can;
- A number of attempts to attract pipeline investments through Code-sponsored tenders have failed; and
- A rather large number of pipelines applying, in most cases successfully, for revocation from the Access Regime.

These trends reflect, amongst other things, a certain disaffection with the Regime, and at times understandably for self-interested reasons. In our view, it is more than that. A unifying theme of these responses is that the predictability or regulatory certainty that investors are looking for is lacking, resulting in a trend towards an aversion to risk, an aversion to the Gas Code, and an aversion to investment and re-investment in pipelines. This could ultimately put the safety and reliability of energy supply at risk.

In this submission, we provide supporting analyses to reinforce the importance of valuing “workable” or effective competition and of investment and the need to refine it. We also make suggestions to reduce the scope of regulation and the manner in which it is applied which we believe will have a direct effect on investment and facilitate competition. We urge Regulators to always consider “why regulate” and to understand the long-term consequences of their actions.

We stress the importance, in assessing the Gas Access Regime, of looking at the broader and big picture of competition reforms and the long-term dynamics of regulatory applications and the responses to them.

## 2 Introduction

### 2.1 Our interest in the industry

KPMG provides a range of services to the infrastructure sector including statutory and internal audit, tax and legal advice, transaction services, corporate finance advice and corporate recovery services.

In addition, KPMG has been and is an advisor to:

- Australian governments on energy sector reform and energy policy generally;
- infrastructure owners on responding to energy sector reform and regulation; and
- regulators on the performance of their assigned responsibilities.

We were financial advisers to the Victorian Government on the reform and privatisation of the Victorian electricity and natural gas industries and to the South Australian Government on the reform and lease of ETSA.

We have subsequently worked on energy policy matters for all Australian governments and most regulators – including the most substantial attempt to conduct a competitive tender consistent with sections 3.21 to 3.36 of the Gas Code.

Over the last 5 years we have worked for most infrastructure owners on network access related issues. We have advised<sup>6</sup> on the following Access Arrangements submitted pursuant to Chapter 2 of the Gas Code:

Pipeline system	State	Period covered
Multinet	Victoria	1998-2002
Stratus	Victoria	1998-2002
Westar	Victoria	1998-2002
TPA	Victoria	1998-2002
AlintaGas	Western Australia	2000-2004
Epic - DBNGP	Western Australia	2000-2004
Envestra	Queensland	2001-2006
Epic – MAP	South Australia	2000-2005 <sup>7</sup>
Multinet	Victoria	2003-2008
TXU	Victoria	2003-2008
Envestra	Victoria	2003-2008

<sup>6</sup> In each of these cases the advisory relationship has been sufficiently substantial to provide us with an understanding of the overall Access Arrangement. We have undertaken less substantial engagements in relation to several other Access Arrangements.

<sup>7</sup> Originally until 2003.

## **2.2 The focus of this submission**

There has already been significant public debate around issues of the National Access Regime to essential infrastructure as a consequence of the PC's 2001 Review on the overall access regime in Australia and the recent EMR on the effectiveness of energy market reforms.

Many of the issues canvassed there remain relevant to this present inquiry, and it is not our intention to repeat or re-run those arguments. Indeed a number of KPMG reports have made arguments that draw on and support the PC Report<sup>8</sup>.

We accept that regulation is a complex and judgemental process. But our own practical experience of working with the Gas Access Regime confirms that, in most cases, the Regime is not working effectively in the interests of Service Providers, Users and Potential Users.

We think the primary reason for this failure is the way in which regulators have discharged their responsibilities under the Regime (and in relation to other energy infrastructure).

After over five years of implementation of the gas and electricity access regimes it is possible to identify a reasonably consistent pattern of decision making by Australian regulators when considering access to energy infrastructure. We refer to this pattern of decision making as the Current Regulatory Paradigm.

The Paradigm first emerged with the decisions of the ACCC and (the then) Victorian Office of Regulator-General in response to Access Arrangements submitted by the Victorian Government in relation to gas network infrastructure in Victoria in 1997. The ACCC "codified" the approach to some degree in its 1999 Draft Statement of Principles for the Regulation of Transmission Revenues<sup>9</sup>.

Further description of the Paradigm has emerged through documents such as:

- International Comparison of Utilities' Regulated Post Tax Rates of Return in: North America, the UK and Australia<sup>10</sup>;
- Draft Greenfields Guideline for Natural Gas Transmission Pipelines;
- Comparison of Building Blocks and Index-based Approaches<sup>11</sup>; and
- Draft Decisions and Final Decisions in relation to electricity asset price review and natural gas Access Arrangements across Australia.

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<sup>8</sup> See, for example, our report, KPMG, Response to the ESC's Draft Decision, August 2002, prepared on behalf of Australian Gas Association.

<sup>9</sup> This document addresses the regulation of the electricity transmission system, but the principles are almost exclusively generic. This document is currently still in draft format.

<sup>10</sup> NERA March 2001.

<sup>11</sup> Farrier Swier Consulting June 2002.

The nature of our work for Government and infrastructure owning clients requires us to understand and interpret the Current Regulatory Paradigm - so that we can provide advice on how best to achieve particular public policy or business objectives for clients.

The following table lists and briefly describes five fundamental value choices implicitly (or sometimes explicitly) made by the regulators applying the Current Regulatory Paradigm.

Issue	Value more	Value less
Conceptual framework	Theoretical constructs drawn from neo classical micro economics. The theory of perfect competition provides the conclusive benchmarks that business proposals must meet.	Legal or commercial constructs based on a 'workable competition' benchmark or addressed to issues that arise in real markets.
Efficiency focus	The <u>theory</u> of productive efficiency – by conducting independent reviews of business specific input costs by 'experts' facing substantial information asymmetries. General discussion of allocative efficiency principles when the widespread adoption of average costing makes such considerations of very limited practical relevance.	The <u>reality</u> of productive efficiency by way of external benchmarking or the adoption of productivity targets from general economy measures. The possibility and importance of dynamic efficiency gains – effectively, we suspect, because the theory of perfect competition does not easily accommodate dynamic efficiency <sup>12</sup> .
Risk allocation	Downside usage risks borne by businesses. Upside benefits to be passed to customers. Operational risks subject to specific identification and valuation by 'experts' facing substantial information asymmetries – or dealt with as a pass through.	Commercial offers to assume and manage risk in return for the possibility of future reward.
Certainty / flexibility	Regulatory flexibility and the discretion to respond to unforeseen changes in circumstances. Maximum 'lock in' is effectively one regulatory period.	Any commitment binding on a future regulatory decision.
Analytic approach	Specific and reductionist. Focused firmly on inputs and on tracking those inputs through to pre-identified outcomes – effectively the regulator as micro manager.	Strategic solutions defined at levels meaningful to consumers.

<sup>12</sup> This is likely to be particularly pertinent in relation to the upstream markets.

We have found that we can generally anticipate what regulators will do in a particular set of circumstances by using this framework.

In our opinion, many of the developments in Australian energy network infrastructure over the last five years simply represent a rational response to the incentives created by the Current Regulatory Paradigm.

What is less clear is that the Current Regulatory Paradigm represents good public policy. Our opinion, based on our practical experience, is that it does not.

We say this from our knowledge of the ways that businesses have responded and adapted to the Current Regulatory Paradigm.

First, there has been a significant number of applications for revocation from the Code. Since the inception of the Access Regime, over twenty gas pipelines have successively been covered under the Gas Code and quite quickly sought to have their coverage revoked within a short time-period. The question needs to be asked as to why this happened and whether this has served the interest of Service Providers, Users, Prospective Users, or the public interest? Why is the burden of proof on the businesses, that they should need to argue "why not regulate"? Certainly, part of this is related to investors' original expectations not having held up. Nonetheless, there is a case for the removal of any presumption that all pipelines need to be covered, and the questions of why, whether, when, and how to regulate to be looked at in each and every case.

Second, businesses have responded by engaging in a significant amount of litigation – notwithstanding the limited opportunities for judicial review afforded by the Regime. It might be reasonable to assume that a transparent, stable and predictable regulatory regime would not create significant demands for litigation. This is particularly because the risks facing the appellant would appear to be heavily skewed on the downside. The appellant faces a high probability of failure and of incurring all the associated costs - meanwhile the regulator gambles with other people's money. The often limited grounds of appeal (e.g. to errors of law) and the discretion afforded to regulators (as highlighted in the *TXU* decision<sup>13</sup>) exacerbate the risk of failure. In addition, the appellant faces all the attendant risks associated with public relations and souring regulatory relationships.

Despite this, the Current Regulatory Paradigm is consistently producing litigation, often relating to fundamental regulatory issues. Some of the most prominent recent examples from the perspective of gas asset owners are outlined below.

- Duke Energy appealed (successfully) to the Australian Competition Tribunal (ACT) on the National Competition Council's recommendation that the National Gas Code cover the Eastern Gas Pipeline;

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<sup>13</sup> *TXU Electricity Limited v Office of the Regulator General* [2001], VSC.

- Epic Energy appealed (successfully) to the Supreme Court of Western Australia on the Draft Decision by the Western Australian Office of Gas Regulation on the Dampier to Bunbury Natural Gas Pipeline;
- Duke Energy appealed (unsuccessfully) to the ACT on the ACCC's decision to draft and approve its own access arrangement for the Wallumbilla to Rockhampton Pipeline System;
- Goldfields Gas Transmission has appealed to the Supreme Court of Western Australia against the State of Western Australia and the Western Australian Independent Gas Pipelines Access Regulator over the setting of regulated tariffs for the Goldfields Gas Pipeline. The regulator is in the process of reconsidering its Draft Decision;
- Epic Energy has appealed to the ACT on the ACCC's decision to draft and approve its own access arrangement for the Moomba to Adelaide Pipeline System; and
- GasNet Australia has appealed to the ACT on the ACCC's Final Decision on its proposed access arrangement revisions for the Victorian Principal Transmission System.

The third trend is that investors have "not turned up" to a number of Code tenders for greenfields opportunities where the underlying economics suggest that gas distribution could potentially be viable. These include the Tasmanian Natural Gas distribution and retail tender, the Loddon Murray Shire gas tender, and the Yarra Ranges gas tender. Distributors' unwillingness to invest within a Code framework mirrors the attitude of potential transmission pipeliners.

A fourth trend relates to the changing ownership pattern in gas (as well as electricity) distribution and transmission. Infrastructure owners have also sought to respond to the Current Regulatory Paradigm by changing risk allocation. For example, there have been significant changes in the ownership of many (private) regulated businesses. Although the distinction between owner operators and investors is somewhat subjective, there has been a significant shift from government to what we would term owner-operators to owner-investors.

The original investment strategy typically involved large US utilities gaining a foothold in Australia's early privatisations (and often paying a significant premium for the privilege), using their expertise to capture efficiency gains and getting a head start in learning how to operate in a brave new world of incentive based economic regulation.

Owner operators have since either been exiting the industry entirely or becoming asset operators and shifting asset ownership to other parties (e.g. those willing to accept the regulators' returns).

There may well be sound reasons for this ownership shift. The key skills involved in asset ownership (e.g. financing) and asset management (e.g. engineering, project management) are certainly different, although these are often combined in a single business with ease in many

cases. Outsourcing some activities can make economic sense<sup>14</sup>, but the Australian market appears to be unique in the degree and speed with which asset ownership is being transferred directly to (essentially) passive investors from owner operators.<sup>15</sup> It therefore appears to be in part a function of the limited scope for owner operators to generate the scale in Australia necessary to justify the investment, and the returns on offer.

It needs to be recognised that passive investors approach asset ownership and incremental investment differently. This is because the motives for the investment are quite different. This is readily observable in other sectors of the economy.

Finally, any code exists within an institutional setting that furnishes Regulators with discretion and accountability for that discretion to differing degrees. The degree of regulatory discretion in Australia is highlighted in the judgement reached by Justice Gillard of the Supreme Court of Victoria in *TXU Electricity Limited v Office of the Regulator General*. Justice Gillard noted in his decision that:

“TXU carries a very heavy burden (of proof) in the light of the flexibility, discretion and judgement making given to the Office in going about its task of price regulation.”<sup>16</sup>

While providing more guidance may enable Regulators to take these principles into account more than they have in the past, it must be recognised that under any likely regulatory environment, Regulators will retain a substantial degree of discretion (although there are ways to narrow it). It is open to Regulators to exercise this discretion in a way that:

- Uses the concept of workable competition and not perfect competition; and
- Has greater regard to the reality of timely investment in natural gas network infrastructure.

The remainder of this submission focuses on providing further analysis or substantiating evidence on the importance of these.

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<sup>14</sup> McKinsey Quarterly, “*Unbundling the unbundled*”, D. Birch and E. Burnett-Kant, 2001 Number 4.

<sup>15</sup> See, for example, Electricity Association, Who owns whom in the UK electricity industry, Policy Research, 21 October 2002.

<sup>16</sup> 2001 VSC, *TXU Electricity Ltd v Office of the Regulator General*, 2001 VSC 153, Para 316.

## 3 “Workable competition”, or competition in real markets

### 3.1 The Epic Decision

The Western Australian Supreme Court in its Epic decision considered that the Western Australian regulator (and by implication other regulators in Australia) have been approaching regulation in a way that is reflective of an underlying “perfect competition” model - which is inconsistent with the Gas Code.

In contradistinction, the Court considered that regulation should be based on a model of “workable competition”.

The clear rationale for proper interpretation of the Gas Code provided by the Epic decision showed that it is open to, and indeed imperative for, regulators to adjust their current approach to one consistent with workably competitive markets and market outcomes, in the following ways:

- Be very clear that the architects of the Code meant section 2.24 to be the fundamental principle that has primacy over section 8 and others, and not the other way round (this is discussed in 3.2);
- Have a greater understanding that their role under the Code is to produce an answer that balances interest and recognises that it is a balancing act, rather than be biased towards a mentality that there is a “right answer” without consideration of the interests (this is discussed in 3.3);
- Make their judgements with a greater appreciation and understanding of how markets work in the real world (for example, in terms of the pursuit of rent, the balance of market power, and how and when the natural monopoly argument may or may not apply) instead of relying on theoretical concepts of how markets could or should work (this is further discussed in sections 3.4 and 3.5); and
- Pay more serious attention to what is happening and to the (actual and emerging) impact of their decisions on the industry, instead of their present bias towards abstract and contested economic concepts, or what those theories (with certain assumptions) suggest the outcomes could be (this is discussed in 3.6).

These are explored in turn in the following sections.

### 3.2 The context: section 8 versus section 2.24 of the Code

In our opinion the Epic decision provided indisputable clarity on how to interpret the Gas Code, which can be summarised as this: in setting prices for access, section 2.24 factors are to be given fundamental weight in the Regulator’s consideration of an Access Arrangement.

Specifically, in response to the Western Australian regulator’s argument that its role was bound by section 8 of the Gas Code and not section 2.24, the Court noted that:

- While Section 8.1 contains the objectives for the Regulator in the establishment of the reference tariffs of a covered pipeline, where section 8.1 objectives conflict and must be reconciled, or in deciding which should prevail, the Regulator should exercise his discretion guided by the factors listed in section 2.24; and in addition,
- When deciding whether the Access Arrangement contains the elements of and satisfies the principles set out in section 3.1 to 3.20, the Regulator shall have regard to the section 2.24 factors as the overriding determinant of whether the Access Arrangement is compliant with the Code.

The fact that Epic Energy was required to take the Regulator to court to have these points clarified essentially reflects how regulators have tended to see their role as setting tariffs and ensuring that tariffs are “economically efficient”, with an insufficient focus on their role as arbiter of a number of objectives and interests.

It is worth reiterating what section 2.24 of the Code says in terms of whose interests the Regulator “must take into account”: the Service Providers, Users and Prospective Users, and the public interest<sup>17</sup>.

This, as established by the Court, takes precedence over any other principles or rules of the Code when a regulator is making its access pricing decisions. Indeed, one could add that it is what the Service Providers who bid for the franchises could have reasonably expected.

### **3.3 Role of the Regulator: balancing interests**

It is an interesting question why regulators in Australia have implemented the Code in a way that reflects insufficient weight given to section 2.24.

We do not doubt that the role of the regulator in balancing interests is a challenging one:

- It is difficult to balance interests when at times the interests are very different and are in direct opposition;
- The information available to the Regulator, as well as the pricing instruments available to balance the competing interests, are imperfect;
- The balancing act also needs to include balancing between short-term and long-term interests;
- In its role in balancing interests, there is the tendency for the regulators to assume the role of an “agent” protecting the powerless public in the face of the powerful pipeline company, but in certain cases (for example, transmission services to large industrial customers) the direct parties do not involve the public at all; and
- Its role as arbiter of interests exists within a context where the transport component of delivered gas is only part of that of its final gas price to the users of gas<sup>18</sup>.

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<sup>17</sup> The WA Supreme Court, in its Epic decision, has rightly highlighted that this section echoes the principles set out in the Hilmer Report. Noted in Epic Decision, at 97.

One could add two other factors:

- The new-ness of the Access Regime and the mixed ownership patterns of the industry which is also only partially vertically unbundled; and
- The delivery of short-term cost savings being an easy “win”.

Noticing this helps us see more clearly the difficult task the regulator has and the potential for error and “regulatory failure”<sup>19</sup>. And it is precisely this potential for error and the nature of the regulatory decision that makes the message of the “asymmetry” in the consequences of pricing error – the costs of erring on the side of investors outweighed by that of erring on the side of consumers – so important and so *relevant*, a message that is at the heart of the Epic Decision and of the recent critique of the access regime. It is imperative that Regulators themselves acknowledge and recognise the real consequences of their decisions.

### 3.4 Promoting competition: competition in real markets

If regulators have been called upon by the Gas Code to play a balancing role, how are they to do so using a concept of “workable competition”?

First, what we observe in workably competitive markets is that all businesses are driven by the pursuit of “rent”. Indeed, the existence and pursuit of rent is often what attracts greater competition in a market, which, over time, leads to rents being dissipated. As the Productivity Commission has observed, “transitory market power is a feature of virtually all markets”<sup>20</sup>. Companies compete on various dimensions (price, quality, innovativeness, brand recognition etc) in order to be able to capture some rent. What we see is reminiscent of what one prominent economist has pointedly reminded us of, that competition is (market or psychological) rivalry<sup>21</sup>, and that Adam Smith, the father of *laissez-faire* capitalism, used the term “in the sense of rivalry in a race”<sup>22</sup>.

The question is then around the source of those rents: do companies compete for rent and attain the capability to capture rent via superior performance or via abusing market power and predatory behaviour (or other means)? It is not easy to distinguish one from the other. A second and related question is around how long those “transitory” rents are kept for.

On the first, it is well known that the asymmetry of information means that regulators cannot always know. The issue is then more about enabling a process and providing incentives that

<sup>18</sup> The CoAG report estimates the transmission component of the final gas price to for a large user to be 21 percent of the total and 11 percent for the distribution customer. COAG draft report, 2002, p.116.

<sup>19</sup> It is interesting that the possibility of “regulatory capture” (the regulatory authorities being captured by the industry it regulates) does not seem presently to be an issue here in Australia. Whether there has been a “populist capture” is indeed a valid question.

<sup>20</sup> PC Inquiry Report, 2001, p.40.

<sup>21</sup> Stigler, J., “Perfect competition, historically contemplated”, *Journal of Political Economy*, 1957, pp.1-17.

<sup>22</sup> Smith’s theory of capitalism and the markets, one may like to note, is also based on a model of human agency that is much broader than that of many contemporary neoclassical economists.

facilitates rent pursuit that is more likely to result from superior performance. That is indeed where the role of balancing interests fit in.

On the second, it is an empirical question how long businesses in other markets keep their rent and the variation both between industries and within the same industry (i.e. between firms), a question that needs to be explored rather than assumed or ignored<sup>23</sup>.

More generally, the activities of companies in workably competitive markets seem close to what one prominent regulator has noted:

*“As a result of learning and competition by rivals firm, the competitive market tends over time to yield prices that reflect efficient costs of production, and to the elimination of excess profits. It tends to encourage the more efficient and profitable firms, those that are better able to discern what the market will want. It also tends to eliminate the less profitable and less able firms. But again, this is only a tendency, not a description of the precise situation at any point in time.”<sup>24</sup>*

This prominent regulator also explained why the “perfect competition” approach is less likely to deliver the desired outcome:

*“...it implicitly uses as a benchmark an inappropriate concept of competition. It assumes that a fully competitive market will generally be characterised by all companies having the same costs and with price equal to that cost. This assumption derives from a static (neo-classical) concept of competition rather than a dynamic (Austrian) concept. The static concept is a hypothetical end-point of the competitive process. To use it as a benchmark tends to underestimate the extent of competition at any time, and hence overestimate the need for regulation.”<sup>25</sup>*

Put more broadly, therefore, to the extent regulation is needed, its role is to facilitate a *process* and not mandate an outcome.

### **3.5 Promoting competition: a note on “natural monopoly” and monopolistic behaviour**

It is important to keep asking the question of “why price regulation is needed” in order to promote competition. To do this, it is worth first clarifying the meaning of and the difference between a “natural monopoly” and a “monopoly” exercising “monopolistic” behaviour.

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<sup>23</sup> There is certainly scope for more work to be done on this issue and not an easy question to answer. Some insights into how “transitory” rent is in kept some other industries and the persistence of “sustainable competitive advantage” can be found in Kay, John, Foundations of Corporate Success, 1993.

<sup>24</sup> Littlechild, S., “Regulators, Competition and Transitional Price Controls: A critique of Price Restraints in Electricity Supply and Mobile Telephones”, 2001, p. 12.

<sup>25</sup> Littlechild, S., “Regulators, Competition and Transitional Price Controls: A critique of Price Restraints in Electricity Supply and Mobile Telephones”, 2001, p. 4.

A “natural monopoly” is the economic term used to refer to an industry or market where “the total costs of production are lower when a single firm produces the entire industry output than when any collection of two or more firms divide the total among themselves.”<sup>26</sup>

The measurement of “natural monopoly” is still a highly contentious area. It is difficult to demonstrate that a particular industry is a natural monopoly over time. As Demsetz has pointed out, “the theory of natural monopoly is deficient for it fails to reveal the logical steps that carry it from scale economies in production to monopoly price in the market place.”<sup>27</sup>

It is important to note also that a natural monopoly may not exhibit monopolistic behaviour and is not defined by it either.

In contrast, “monopoly” is a concept in economic theory that is used to refer to a market or an industry with only one single player. In practice it is not commonly found in the real world, but is used as a conceptual tool to guide thinking about whether a company has engaged in monopolistic behaviour<sup>28</sup>. It is well known that a monopolist can increase its profits by practising price discrimination. It is also worth noting that monopolistic behaviour is quite possible and found in industries with no or very little “natural monopoly” characteristics.

Most countries deal with anti-competitive behaviour or monopolistic behaviour (as well as the related issues of market power, predatory pricing etc) through antitrust or a competition law. And indeed the framework they use is that of workable or effective competition when assessing, for example, whether a takeover substantially lessens competition.

It may be worth belabouring the first issue a little more. Even disregarding the doubts a number of prominent theorists and practitioners have thrown on the possibility of definitively identifying natural monopoly<sup>29</sup>, the presumption that transmission pipelines are a natural monopoly in the Australian context is interesting. It is worth comparing our situation with the English situation.

While Transco is the only gas transmission company in England, this is certainly not the case in Australia. At privatisation in England, there was a well-developed national transmission network already in place; the whole of that network was privatised intact, and thereafter the network was regulated under access regulation. The situation is quite different in the development of Australia’s gas transmission pipeline network<sup>30</sup>.

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<sup>26</sup> The New Palgrave Dictionary, 1987, p.603.

<sup>27</sup> Demsetz, Harold, “Why regulate utilities?”, *Journal of Law and Economics*, April 1968.

<sup>28</sup> For example, the so-called hypothetical monopolist test or the SSNIP [small but significant non-transitory in price] test.

<sup>29</sup> There have been some industries that had previously been seen as a natural monopoly but where “contestability” has since taken place.

<sup>30</sup> That the regulatory problem needs to be considered in the context of the particularities of Australia’s gas markets is an issue requiring more analysis in order to inform the present debate. These analyses need to be not only on how third-party access in other countries have not prevented investment, but need to show a broader

### 3.6 Promoting competition: the markets and drivers of competition in transmission versus distribution markets

The question of “why regulate price at all” also needs to be considered in each case. Importantly, the burden of proof should not be placed on businesses, who also should not have to be forced to go through revocation in order to prove why they should not be regulated. Why *were* they regulated in the first place then?

What can we find in the gas markets if we are guided by the workable competition framework? What is the nature of the markets in natural gas? How has the Gas Access Regime affected the way competition operates or is allowed to operate in the markets?

First, let us look at what is so crucial about the transport of gas. First, the importance of pipelines comes from the role they play in “transporting” the gas from where it is produced (upstream), to the customers who wish to use gas (downstream), thus connecting the markets of supply and demand<sup>31</sup>.

Second, a major characteristic and the importance of this “transport” link is that it requires heavy capital (and often sunk) investment and, some would argue, it has natural monopoly characteristics (see also our discussion in 3.5).

Gas in Australia is essentially used to service two quite different markets. The first are power stations and other major users of gas; often gas is connected via transmission pipelines lines to these big customers. The second are business and residential markets, where gas is used for purposes that are important, but not critical or substantial (as a component of the total cost structure of the enterprise or household).

If one moves away with the presumption that all pipelines are natural monopolies and the associated difficulties and risks with that presumption, and analyse the situation in terms of market power, the questions need to be asked: Who is doing what in the production, transportation, and the supply of gas to the end-users in each case? What are the sources of competition in these markets? Who could be exercising market power in each case? Are there other market participants present who may provide countervailing power?

The following table provides a simplified picture of a primary customer type from each segment:

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understanding of the physical endowments (and constraints), the historical factors, and the institutional endowments of a country.

<sup>31</sup> Some call it the “bottleneck” property thus giving rise to “congestion” theories.

Market served	No of players			Competitive pressure / countervailing power
	<i>Producer</i>	<i>Transporter</i>	<i>Customer</i>	
Power generator	A few	One (sometimes more)	A few	Transporter does not have a geographical franchise; threat of bypass.  Competitive pressure from coal in downstream markets.  Customers who want transmission services are often large enough to negotiate their own deal and also have the choice to go to a retailer.  Transporter vertically unbundled.
Residences	A few	One	Many	Transporter has a geographical franchise.  Competitive pressure from electricity in downstream markets.  Transporter vertically unbundled.

In the context of the presence of countervailing power, the need for a regulator to step in as “agent” of the small customers seems greater than that for a regulator to step in as “agent” of the big power generators (subject to the qualification mentioned earlier in 3.3). And even in the case of distribution systems, it is the retailers who seek access, and not the end customers.

Is the transmission pipeline able to exercise market power? This is not clearly the case when transmission pipeline customers are very small in number, are very informed buyers, and often have dominance (e.g. producers who are also owners and developers of pipeline assets, or they are a large customer in terms of purchasing volume) over the pipeline companies themselves<sup>32</sup>.

Additionally, there are significant commercial incentives on vertically unbundled network companies with spare capacity to provide access. The practical incentives to refuse carriage under these conditions are, in some cases, relatively low.

Indeed, that pipeline owners are at least in some cases far from being able to exercise power and are subject to competition comes from the fact of competing proposals to serve the same markets (and sometimes the same customers). These pipeline projects are contestable *ex ante* at the construction phase. There is competition *for* the market as against competition *in*

<sup>32</sup> A comparison could be the LNG tankers that connect the producers of LNG and the markets for LNG.

the market, and different solutions (and not necessarily regulation) can be found for different cases with different circumstances<sup>33</sup>.

Put more broadly, in many cases, the question of “why regulate price at all” needs to be considered.

A further and crucially important point needs to be made here. Looking at the gas markets as a whole and understanding markets in real ways in fact raises the issue of concentration at the gas production end. The issue is not only that the availability of competing sources of gas is an important constraint on the potential gains from competition under third-party access<sup>34</sup>, it is also that taking all or a large part of the “rent” out of the pipeline segment of the industry chain may simply result in a *re-distribution* of rent to the other parts of the chain (likely to be the gas producers).

It would indeed be ironic if the operation of the Gas Access Regime aimed at facilitating competition has actually resulted in competition being delayed at the downstream markets and slowed the increase of upstream competition.

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<sup>33</sup> Auction is an approach used quite frequently especially in the telecommunications industry. Laffont & Tirole (2000) has a discussed some good examples of the creation of both in-market and for-market competition in splitting spectrum awards in auctions. Laffont, J-J, & Tirole, Jean, *Competition in Telecommunications*, 2000, chapter 6.

<sup>34</sup> Many other countries have had to face this issue.

## 4 The role of the Regulator in valuing investment

### 4.1 The Review of the National Access Regime

The idea that the risk of too little infrastructure investment is far greater than the risk of too much investment, and that there is asymmetry in the consequences of regulatory pricing errors, was well established by the Productivity Commission's 2001 report on the National Access regime.

The reasoning is based on a recognition that access pricing would, ideally, involve prices low enough to protect access seekers and end customers from the exercise of monopoly power, but also high enough to provide sufficient incentives for the Service Provider to make the investments needed to continue to deliver the services at efficient levels of quality and quantity. In practice, however, such ideal conditions are seldom realised. Indeed, the information asymmetry means that regulators have a high level of uncertainty and a high risk of error. The consideration then is that the costs of the regulator committing one error – over-compensation – is much less than the other error – under-compensation<sup>35</sup>.

A strong message from the Productivity Commission's 2001 Inquiry Report is that Regulators have erred on the side of low prices at the cost of investment. Indeed, the present operation of the National Access Regime “does not do enough to guard against the possibility that investment in essential infrastructure will be deterred”<sup>36</sup>, and “the case is compelling” to provide “specific measures to facilitate new investment”<sup>37</sup>.

The investment issue bears further analysis as it is an important one. In the following we provide some concise analyses to highlight the need to:

- Protect against the risk of under-investment especially since the costs are delayed and often not so easy to detect (section 4.2);
- Recognise that investment behaviour is part of the “discovery” or “learning process” that takes place naturally in an effectively competitive market (section 4.3); and
- Understand that those who are considering “investing” in a new pipeline look at things a little bit differently from the marginal investor considering “investing” in a share of a company (section 4.4); and
- Recognise that investors value predictability and stability highly (section 4.5).

Finally, we take note of the Regulator's discretion and power and the implications for the limits of their power and responsibility (section 4.6).

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<sup>35</sup> The two types of possible errors – over-compensation versus under-compensation – and the consequences are referred to as Type I (false alarm) and type II (failed alarm) errors in statistical terms.

<sup>36</sup> PC Inquiry Report, 2001, p.xxi.

<sup>37</sup> PC Inquiry Report, 2001, p.xxv.

## **4.2 The need to look after long-term, delayed costs**

One of the complexities involved in regulation is that, in the case of a poor or unreasonable regulatory judgement, the negative consequences – insufficient investment being one possibility – only start becoming clear after a certain time period. In other words, many of the costs of poor regulation are delayed costs.

We see this as not only or simply an issue of small immediate costs as against big potential delayed costs. It is also that the present costs (e.g. high price) are much easier to see while the delayed cost (even higher price, but in the future) are less so.

The issue is important because we can envisage a situation where a trend of under-compensation result in services continuing but maintenance being cut back, new investments being deferred, and the full extent of the problem only becoming apparent when the impact of these accumulate. This trajectory where an industry encounters a slow and incipient decline due to lack of investment is a particularly worrying one as every industry in the economy is dependent on the effectiveness of the energy supply industry. This is perhaps even more pertinent in the Australian context where the natural gas industry is still in its growth phase.

## **4.3 The risk of over-investment unbundled**

The second issue is that the so-called “over-investment problem” may not be something to be feared so much if it is unbundled and the cost of over-investment is understood in terms of who bears it and in terms of what is to be expected when real world markets operate.

If one thinks for a moment about what may be the consequences of over-compensating investment, one may come to see the likely dynamics: while in the short run the pipeline owners may be able to apply a higher charge for transporting gas (and more investment may occur as a result of capital “piling in” to take advantage of the opportunity for rent), in the longer-term the proliferation of pipelines will mean that there will be “over-competition” and tariffs will come down. In a lot of real world markets, this is a natural occurrence. That capital piling in could lead to inefficient duplication of investment is certainly a legitimate concern, but compared with the alternative where the Regulator under-compensates, over-compensation leads to conditions where the market works out for itself where to land.

Perfect investment timing does not occur in any real world industry or within any company. A certain swing in investment takes place as a natural consequence of competition in real markets. Businesses cannot always “get it right”, they need to test things out, and experiment with ideas. Indeed, periods of over investment (or irrational exuberance) separated by periods of lower or under-investment is part of the “discovery” process that takes place as part of the normal course of business.

And indeed it is the investors who bear that cost.

#### 4.4 Understanding the “investment decision”

Yet another facet of the “investment problem” needs to be highlighted. And it is a simple one: those who are considering “investing” in a new pipeline look at things a little bit differently from the marginal investor considering “investing” in a share of a company. Regulators need to take into account the practical realities of financing a pipeline in implementing regulation. They need to not just pay lip service to that, but rather they should base their regulatory approach on a real and pragmatic understanding of these investment and financing issues.

The ACCC completely missed these implications from a paper on pipeline financing that it itself commissioned<sup>38</sup> in preparation for its Draft Greenfields Guideline for Natural Gas Transmission Pipelines<sup>39</sup>.

A few points to draw out about the investor who is considering “investing” in a new pipeline and his or her world<sup>40</sup>:

- Any investment project will have a changing risk profile over its life-cycle, and this is particularly the case for a project with a long time-horizon, which is capital intensive with largely sunk costs, and where construction can take some time. The contrast between the pre- or in-construction phase and the post-construction phase is particularly clear – the reason why projects are often refinanced quite soon after operations begin<sup>41</sup>; and
- If greenfields projects are essentially allowed to earn similar rates of return as established brownfields pipelines, it is not a wonder, all other things being equal, that pipeline owners earning an average rate of return on operating established, brownfields pipelines are not incentivised to take the risk inherent in the early parts of a greenfields pipeline project<sup>42</sup>. Compounding this is when the regulatory process seems to do a poor job

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<sup>38</sup> Macquarie Bank, Issues for debt and equity providers in assessing greenfields gas pipelines, May 2002, available online at: [http://www.accc.gov.au/gas/br\\_reg\\_iss/macquarie\\_bank.pdf](http://www.accc.gov.au/gas/br_reg_iss/macquarie_bank.pdf) (“the Macquarie report”).

<sup>39</sup> ACCC, Draft greenfields guideline for natural gas transmission pipelines, June 2002.

<sup>40</sup> Our comments in this section is intended to highlight that in certain situations theories based on the “marginal” investor need to be applied with an understanding of the assumptions behind them, and certainly not to be interpreted as saying that they are of no use or to be discarded.

<sup>41</sup> Lower financing costs are often achievable, sometimes enhanced with the opening up of capital markets funding options. This is also referred to in the Macquarie report, pp.7-8.

<sup>42</sup> This issue is drawn out a little bit in the ACCC’s Consultative Forum on the Greenfields Gas Guidelines, held on 19 November 2002, where the question of finding a “beta” (under the CAPM model) that relates to a company that is only engaged in greenfields pipelines was raised. In effect, the “beta” that relates to the equity that supports a greenfields pipeline cannot easily be observable or identified, not least because some of these equity are privately sourced. The possibility of a comparative benchmark in toll roads projects is complicated by the fact that returns on toll road projects are not typically regulated and that the tollroad concessions are often granted for a defined period, typically 20 years. Minutes of the Forum are available online at: [http://accg.gov.au/gas/br\\_reg\\_iss/Minutes\\_Forum.pdf](http://accg.gov.au/gas/br_reg_iss/Minutes_Forum.pdf).

(delays etc) in reducing that uncertainty when the cashflows are potentially subject to what the regulator allows under the Code.

Indeed, a look into historical patterns of infrastructure investment provides some more hints: In many countries, pipeline development and expansion were either undertaken when the industry was private, but not regulated and returns were high (e.g. US in the 19<sup>th</sup> century), or under state ownership where the (assumed) cost of capital was low (the State effectively underwrote those investments).

A stylised comparison between the “strategic” investor and the “marginal” investor on two dimensions, couched in general terms, may also be helpful<sup>43</sup>:

Strategic investor	Marginal investor
Cannot (and does not plan to) exit any time – longer-term commitment	Can exit any time
Can often exert direct and significant influence on strategic decisions	Limited influence on strategic decisions.

Properly understanding the investment decision is important because the delivery of gas to end-users is a direct result of these parties’ investment decisions, and in most cases they make that investment decision by committing their own equity<sup>44</sup>. The marginal investor, by comparison, is able to exit their equity position any time they wish<sup>45</sup>.

#### **4.5 The importance of predictability and investor expectation**

In the practical world, it is always the decision to build something that starts a business (or a pipeline), and not the theoretical world of supply meeting demand. An entrepreneur observes a demand for a service or product and makes a (financial) decision to provide the means (capital and other resources) to satisfy that demand.

Investors always face risk. What is at issue here is the substantial additional “regulatory risk” they face. This is particularly the case when the discretion of the regulator’s pricing powers is wide. What is also at issue is how the Regulator at times shoulders risks for businesses (ultimately passed on to the public) that in a normal, unregulated market, are risks that are best left to the businesses themselves to manage.

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<sup>43</sup> This is not meant as an exhaustive list of differences. The present discussion is meant to be illustrative. See also footnote 40.

<sup>44</sup> To note that these equity could ultimately come from the “marginal investors” of this world and to draw a straight line between that investment decision to the other is reductionist.

<sup>45</sup> There is a parallel at the macro level between capitalist financial systems that are based on long-term and committed equity and those that are not.

Our experience tells us that investors always value predictability and stability, whether they are investors considering extending or expanding their investment in Australia's regulated gas pipelines, or investors considering making a foreign investment in building a factory here. Investors are always dependent on and value a stable and well-conceived regulatory and institutional environment. In other words, investors look for a level of "regulatory risk" that is manageable. Regulators need therefore to fully recognise that what they do at regulatory resets directly impacts on and creates risk for:

- How businesses respond over the next regulatory period (whether they expend their time and energies in maximising profits through growth and innovation, investment and re-investment into the business, or whether they expend their time and energies in minimising risk through risk reduction and risk shifting) and what they expect at the next reset; and
- How investors perceive "regulatory risk" when considering investing in extending and / or expanding their investments, whether in a new "greenfields" pipeline, or in their eagerness in upgrading existing ones, or in the timing of investing in R&D to improve existing pipeline technology.

There is a direct link between past, present and future. Future expectations are framed by the contrast between current outcomes and past expectations. The importance of predictability and stability of regulatory action and of expectation in ensuring continued investment (whether in improving existing assets or new assets) is an age-old theme, and certainly one that the original Hilmer reform was clearly cognisant of.

#### **4.6 A final note on regulators' "discretion" and power**

Finally, regulation also needs to be undertaken with the clear recognition that not only are consequences of poor outcomes delayed, but that there are limited ways in which a business can seek redress in case of a poor regulatory outcome:

- They can either seek legal redress – which is currently both difficult and costly; or
- They can seek the "exit" avenue – offer their ownership interests up to interested buyers.

In fact, businesses have been doing both in Australia, as already pointed to at the beginning of this paper. In addition, they have also refused to turn up to Code tenders with (attractive) offers; nor have they spared efforts in (successfully in the most part) trying to get their coverage under the Code revoked. This reflects, amongst other things, a significant disaffection with regulatory outcomes and the Current Regulatory Paradigm.

What else can businesses do? There are two things to note here:

First, while in an "electoral contract" voters can vote the politician out after 3 or 4 years, and while in a "market contract" often one party can re-write or terminate the contract in case of

under- or non-performance, in the case of the “regulatory contract”<sup>46</sup>, not a lot can be done (at least as the regulatory contract is currently constituted).

Second, if one looks at the long-term dynamics of what businesses’ responses have been, one may come to the following question. In the last instance, who may be left that is interested in owning these businesses? In a situation where no private business is interested in taking an ownership stake, it may then become clear that the regulator has performed very poorly, but would that be too late? This is but one other instance of delayed cost (already noted in section 4.2)<sup>47</sup>.

The other option businesses have is to spend large amounts of time and effort managing the Regulator and shifting risk out of the business, or finding more innovative ways to keep the regulatory sanctioned rent (thus we come back to our earlier discussion of the source of rent in section 3.4).

In all, this suggests a need for limiting the Regulator’s power, or at least providing stronger checks and balances to it. There needs to be strong and independent institutions that ensure greater accountability of the regulators and the reasonableness of regulatory decisions. We thus come back to the question of the role of the regulator, and the question of who the regulators need to be accountable to and for what?

In our view, they need to be accountable to the long-term interest of Service Providers, Users, Prospective Users, and the public interest. They need to be accountable to the promotion of competition in the gas industry in the nation. In doing so, they need to be cognisant of the particular conditions of Australia’s gas industry which is in its growth phase and where the pipeline network is not very well developed yet and thus the need for significant investment to bring the country’s abundant supplies of gas to customers. They need to always think about “why regulate” in specific situations and why their services were called into being in the first place: to promote competition.

If changes are not implemented, the next questions that will come and some will be asking are not how to change the way the Gas Access Regime is applied to make it better, but ways to remove or bypass the Regime and the Regulator altogether.

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<sup>46</sup> Some have written about this at length; see, for example Newbery (2000), where the “problem of regulatory commitment” becomes one that needs to be looked at in securing successful reform. Williamson (1985) also provides insights in his analysis of regulation contractually as a highly incomplete form of long-term contracting whose effective enforcement may require institutionally different solutions in countries with different institutional matrices. Newbery, David, 2000, *Privatisation, Restructuring, and Regulation of Network Utilities*. Williamson, O., 1985, *The Economic Institutions of Capitalism*.

<sup>47</sup> This issue has manifestly presented itself in the news internationally just as this submission was being drafted. For two interesting commentary, see John Kay in the *Financial Times*, “Cutting costs and services”, 21 August 2003, and Robert Samuelson in the *Australian Financial Review*, “Electricity’s dark future”, 21 August 2003.

## 5 Some concluding thoughts

### 5.1 What now?

At the outset of this paper, we highlighted the fact that both the Productivity Commission and the Energy Market Review identified the regulatory implementation problem of the National Access Regime and provided a clear rationale for change. Our practical experience of the Gas Access Regime over the last six years is consistent with that view.

In our opinion, there is a need, and this is the opportunity, for the regulatory regime to be realigned on terms more consistent with the policy makers' original intention as reflected in these recent critiques of the Current Regulatory Paradigm.

In relation to the scope of the Gas Access Regime, we propose that it be reduced by:

- Excluding greenfield transmission pipelines (under certain simple conditions if necessary); and
- Excluding situations where competition is in place with more than one major pipeline serving the same downstream market (under certain simple conditions if necessary).

In relation to the Code, we propose that it be redrafted in a way that:

- (for all sections) ensures regulators place greater regard to investment outcomes and the longer-term interests of the public;
- (for section 3) reduces the incentives of Regulators to micro-managing Code tenders; and
- (for all sections) reduces references to "economic efficiency" that have been interpreted within the Current Regulatory Paradigm in such unhelpful ways.

In relation to the way in which the Regime is applied at regulatory resets of pipelines to continue under regulation, we suggest that Regulators give lesser emphasis to a revenue-based type of approach, and to focus their minds on incentives for businesses to be innovative and superior in service provision.

In relation to the institutional settings under which the Code exists, we propose that the accountability of the Regulator be strengthened via a broad provision for merit-based reviews.

More generally, though not less importantly, regulators need to ask the question of "why regulate". The burden of proof should not be on businesses to prove "why not regulate" but on the Regulator to prove "why regulate". Put another way, we ask the Regulator to see the part of the world (currently eclipsed) that seeks answers to "who and how not to regulate prices" and to de-focus their vision on the part of the world that seeks answers to "why and how to regulate prices".

We suggest also that the Productivity Commission consider conducting an exercise to assess the benefits of the Gas Access Regime.

Indeed, it was Hilmer who wrote:

*"The Committee is conscious of the need to carefully limit the circumstances in which one business is required by law to make its facilities available to another. Failure to provide appropriate protection to the owners of such facilities has the potential to undermine incentives for investment."*<sup>48</sup>

And:

*"... when considering the declaration of an access right to facilities, any assessments of the public interest would need to place special emphasis on the need to ensure that access rights did not undermine the viability of long-term investment decisions, and hence risk deterring future investment in important infrastructure projects."*<sup>49</sup>

We reiterate our hope that this paper and the Review itself will provide impetus for more thinking on understanding and analysing the long-term dynamics of the Australian regulatory regimes.

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<sup>48</sup> Independent Committee of Inquiry into Competition Policy in Australia (chaired by Professor F. Hilmer), 1993, National Competition Policy: Report by the Independent Committee of Inquiry into Competition Policy in Australia ("Hilmer Report"), p.248.

<sup>49</sup> Hilmer Report, p.251.