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Mr G Banks
Gas Access Regime Inquiry
Productivity Commission
LB2 Collins Street East
Melbourne VIC 8003

Dear Mr Banks

Submission on the Review of the Gas Access Regime

The Australian Council for Infrastructure Development (AusCID) appreciates the opportunity to provide a submission to the Productivity Commission on the inquiry into the National Third Party Access Regime for Natural Gas Pipelines (Gas Access Regime).

As a representative of investors in pipelines, AusCID is concerned about the effect that recent decisions under the Gas Code may have had on pipeline investment in Australia. While the Gas Code has provided a national regime for dealing with access issues in the gas sector, the implementation of the Code has led to considerable regulatory uncertainty and acted as a disincentive to investment. Experience with the Code has also shown a number of areas in which the regime needs to be clarified and improved.

This submission is intended to address the aspects of the Code which AusCID considers to act as a discouragement to investments in new and existing pipeline infrastructure and which will not promote the original objectives of reform of the gas industry. The submission also makes some suggestions as to how the Code should be amended to promote decisions on access arrangements that are in the best long run interests of both consumers and investors in essential infrastructure.

AusCID's Position on Regulation

AusCID believes that the essential purpose of an open access regime should be to allow and promote competition that has the capacity to reduce consumer prices, facilitate infrastructure investment and catalyse demand growth.

There is a range of severe limitations to the current format of the Gas Code, in particular:

- it fails to provide potential investors in regulated infrastructure assets with sufficient pre-investment certainty on key parameters that regulators establish, such as the allowed return on assets;
- the competitive market model used under the Gas Code for pricing purposes is inconsistent with encouraging dynamic incentives. By focussing on short-term price reduction, the framework provides little incentive to make large sunk investments. Regulated prices that are set too low may ultimately lead to inefficiencies including inadequate maintenance, lack of innovation and limited capacity;
- legislative arrangements are very complex and carry significant risk of being misinterpreted by the regulator. The most recent outcome of the Epic Energy judgement in favour of the energy provider was based on a number of errors of law made by the Western Australian regulator. The decision implies :
 - regulators may not apply the perfectly competitive model; and
 - the form of regulation should emulate the workably competitive model;
- the regulatory test, in its current form, can have an adverse impact on investment in transmission capacity in Australia. With its focus on maximising market benefits based on costs alone, the regulatory test hurdle has the potential to deter viable investments that would have otherwise gone ahead. AusCID therefore believes that the test should be changed to "workable" competition as set out in the Epic Court decision.

As a result, investors increasingly perceive Australia as a high regulatory risk jurisdiction and are reluctant to invest in assets that have a high probability of being regulated.

It is AusCID's view that the Gas Code should be amended to include meaningful incentives for pipeline owners to meet anticipated market growth with timely incremental expansions. Pipeline owners must be encouraged to take the risks associated with the construction of spare capacity by establishing realistic incentives in the Code, including the opportunity to earn returns which are commensurate with the risk of involved in constructing pipeline projects.

In short, for the regulatory framework to meet the public interest and to achieve the best possible outcome in both economic and social terms, it should be designed so as to promote dynamic efficiency and encourage long term investment in infrastructure assets. Investors in regulated infrastructure require a high level of certainty on regulation, and confidence that adequate returns on their investment can be achieved while maintaining fair prices for consumers. The Gas Code should therefore be structured so as to:

- promote investment in transmission services to support the development of the Australian natural gas market;
- promote maximum economic efficiency and provide pipeline access on the lowest commercial terms feasible;

- minimise regulatory intervention in regulated businesses' decision making processes and have a low cost of administration;
- create certainty about key parameters prior to investment and therefore minimise perceived regulatory risk;
- promote co-operative relationships to achieve best possible outcomes for all stakeholders;
- maintain appropriate returns for investors and fair prices for consumers.

Additionally, the Gas Code should be aligned with any measures to facilitate infrastructure development that emerged from the Productivity Commission's review of the National Access regime. In particular AusCID believes that the Code should be amended to provide for:

- access holidays for greenfields pipelines,
- long term enforceable access undertakings (15-20 years); and
- a merits review.

Alternative Models of Regulation

AusCID considers that the level of access regulation should be consistent with the ability of the regulated entity to exert market power and to refuse access:

- Many companies are not vertically integrated and as such have no incentive to refuse access. The Productivity Commission has used this reason in the review of airports to argue against the use of Access Arrangements to regulate airports. It was also supported by the ACCC in its submission to the airport's review, which stated " When a service provider is vertically separated it will usually have little incentive to deny access. While a service provider may exploit its market power by setting higher prices it is unlikely to manipulate other terms and conditions to limit access. Nevertheless the negotiate-arbitrate provisions allow an access seeker to seek arbitration over non-price terms and conditions. This could result in unnecessarily intrusive arbitration over detailed operational matters." (p.335 Review of Airports);
- Distribution and transmission prices flow through retailers and to final customers all who can monitor and complain about price increases and produce a countervailing power to monopoly prices. With retail price caps its even more likely retailers would complain about price increase from distributors and transmission companies. Even with an associated retailer a distributor would be constrained from increasing prices by larger customers, industry associations, lobby groups and newspapers. However, a company owning a retailer Other vertically integrated companies may need to give a voluntary undertaking on open access to be price monitored;
- The Productivity Commission has supported the idea that once a company had been through two Cost of Service reviews it could move to a more light handed pricing approach because its costs should be efficient and the costs of the price control model

are too high. Price monitoring is the next logical step in the regulatory model that is appropriate when costs are efficient.

- The threat of possible re-regulation will encourage negotiated pricing outcomes based on efficient costs and an adequate return on capital. A review would be conducted towards the end of a five-year period to determine whether there have been unjustifiable price increases that warrant reimposition of price controls. A reserve right to bring forward the review, or conduct a separate review, if it appears that there have been unjustifiable price increases may also be part of the move to price monitoring to provide sufficient protection to users.

Price Monitoring

AusCID recommends that price monitoring, combined with a commitment to open access and a credible threat of more heavy handed instruments to prevent abuse of monopoly power, be extended to gas transmission and distribution as a lighter-handed alternative to price caps or cost-based regulation.

The key advantages of price monitoring over heavy-handed price controls include:

- its ability to significantly reduce regulatory risk and to offer the investor high certainty and a greater pre-investment understanding of the regulatory environment;
- because of the relatively low levels of regulatory intervention in price-setting there is less opportunity for regulatory error and consequent distortions;
- it best meets the requirements of a “workable” competitive market where customer welfare is maximised through encouraging price service offerings that best meet customer needs;
- it is less information intensive and therefore relatively inexpensive to administer; and
- it best encourage commercial negotiations.

Price-Service Offerings

Price-service regulation is another preferred alternative to heavy-handed price control, and could be applied to businesses that can differentiate in terms of price and product quality. It is designed to replicate workably effective competition by focusing on flexibly responding to what customers actually want from their service provider in terms of service attributes such as quality, reliability, and service levels.

Under price-service regulation, prices and services are set and offered to the market according to customers’ preferences, rather than determined by the regulator. The regulator and customers participate in the development of packages of services that reflect overall customers’ needs and preferences.

Price-service offerings would contain specific targets for particular service attributes such as quality and reliability, and by setting service standards according to customer preferences price-service regulation mimics what happens in real world workably

competitive markets. Additional protection to the consumer from the abuse of market power would be provided by the Trade Practices Act.

The key potential advantages of price-service regulation are:

- It is truly incentive-based in that it rewards innovation, market-responsiveness and the development of new services;
- It matches supply of and demand for services, with customers receiving services tailored to their needs;
- It reduces perceived regulatory risk because the more clearly specified mechanism for setting tariffs and service levels; and
- It provides greater flexibility to respond to customers' needs.

In conclusion, AusCID believes that a flexible regulatory framework that is less intrusive and permits regulation by either price monitoring or - as far as applicable - price-service regulation is best placed to encourage regulated businesses to meet consumer needs while meeting the policy objective of a competitive market approach.

Once again, we appreciate the opportunity to comment on the above process, and hope that you find these recommendations useful.

Yours sincerely

A handwritten signature in black ink, appearing to read "D. O'Neill". The signature is fluid and cursive, with a large initial "D" and "O".

Dennis O'Neill
Chief Executive Officer
AusCID