Review of the Gas Access Regime

Submission to the Productivity Commission by Professor Stephen C Littlechild

**on behalf of
Allgas Energy Ltd and ENERGEX Limited**

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<u>SUBMISSION ON REVIEW OF GAS ACCESS REGIME</u>

The Productivity Commission *Issues Paper* on its *Review of the Gas Access Regime* raises some timely and pertinent questions about the gas sector in particular, and about network industries in general. It seems worth putting the issues in the broader context of accumulating international experience and the development of economic thinking.

Over the past two decades, there have been significant changes in the regulation of infrastructure businesses internationally. These changes include a greater distinction between the activities of building, operating and developing the networks, and the activities of providing services over the networks. The aim has been to promote competition in the provision of services over the network, with a view to reducing or removing regulation wherever possible.

In contrast, network provision has typically been seen as a monopoly activity. The traditional concern has been to ensure that users of the network receive good service are not exploited as to price. The innovation in recent years has been to complement this by the introduction of incentive regulation: that is, to seek to ensure that the specified quality of service is provided in the most efficient way.

This is typically done by providing inducements to the network providers to discover lower cost production methods. For example, the regulator might set a cap on the prices that can be charged, to apply for a period of years, while allowing the network providers to keep the value of any cost reductions during the period of that price control. The expectation is that, in resetting the price caps, customers will receive a share of the cost reductions achieved.

In the UK, and increasingly in the US and elsewhere, this incentive framework has been very successful in increasing efficiency and reducing costs of network businesses in the gas, electricity, telecommunications, water, airport and other sectors. At the same time, the framework has maintained and often increased quality of service, and allowed adequate returns to investors.

However, there is more that could and should be done to provide yet greater benefits to customers, particularly as the scope for further reductions in costs is increasingly limited. Two possibilities are suggested here.

Coverage of regulation

The distinction between competitive and monopolistic activities is not necessarily fixed, and it deserves review. For example, telecommunications networks are not necessarily monopolistic, and over time new entrant competitors have begun to provide networks to rival those of incumbents. This brings competitive pressure to bear on all concerned, resulting in more attractive terms and new ideas for products and services. But concern has also been expressed that unduly severe regulation of network prices has discouraged or restricted the development of such competition. Certainly, where regulation has depressed the retail prices of gas and electricity, the development of retail competition has been much retarded.

Thus, the purpose and nature of network regulation needs to be kept under review. There may be merit in tough regulation of monopolies, designed to minimise price consistent with rewarding efficiency. However, in a potentially competitive market the advantage is in relaxing and ultimately removing the regulation of prices, so as not to discourage new entry and investment, and so as to encourage the development of competition to provide network services.

Gas networks seem to be a case in point. Customers often have a choice whether or not to use gas, gas retailers have a choice of pipelines, there is competition to build new pipelines, and the building and extending of gas distribution networks has to compete against the provision of other fuels. In such circumstances the need for regulation is substantially reduced. At the same time, the potential costs of regulation – in terms of "getting it wrong" and discouraging investment – can be quite significant.

The Productivity Commission is therefore right to look at the possibility of reducing the scope of gas access regulation. The Commission asks whether improvements are needed to the objectives specified in the preamble to the Act. It is notable that, reflecting the full title of the Act, the objectives focus almost exclusively on the conditions of access to the existing network of transmission and distribution pipelines. They have little to say about the importance of providing an environment in which it is attractive to build such pipelines in the first place.

The Commission asks whether the current coverage test is appropriate. The Gas Code states that the National Competition Council (NCC) must recommend that a pipeline be covered by the Gas Access Regime if and only if it is satisfied that a number of conditions apply. These conditions include that access to the services would promote competition in another market and that it would be uneconomic for anyone to develop another competing pipeline.

These conditions seem to assume that regulation can only be beneficial. But this is not the case: as noted, regulation can severely reduce incentives to enter and compete. Accordingly, the conditions might be expanded to require the NCC to be satisfied that regulatory coverage is actually needed, in the sense that competition in other markets would not be promoted in its absence. The conditions might also require the NCC to be satisfied that regulatory coverage would not discourage the development and operation of further pipelines.

More generally, any proposal to introduce or extend regulatory coverage should have to establish the absence of disadvantages as well as the existence of potential advantages. There might also be an obligation to review the need to continue existing coverage. The NCC might be required periodically to establish that the balance of advantage lies in continuing to maintain regulatory coverage of each network. In the absence of such justification, regulatory coverage would be removed.

Innovation and quality

Even where market power is such that access regulation of some gas networks cannot be withdrawn, there are nonetheless things that can be done to reproduce some of the benefits of a competitive market process within these networks. The competitive market process is not limited to efficiency, cost and price alone. Importantly, it also extends to quality, and to innovation in the services provided.

Conventional regulation has little to say about such matters. It tends to take the nature of the product as given, or at most to impose conditions to avoid a decline in quality. Yet even in monopoly networks there is scope to improve quality and to introduce new variants of service that all or some customers might prefer to the existing or specified level.

The difficulty is to know what new and alternative services might be produced, and whether customers would value these. Unfortunately, regulators know relatively little about such matters. Where competition is viable, it serves as a discovery process. Where competition is not viable, the regulatory process has to act as a substitute. The regulatory process therefore needs to encourage network companies to design and offer services that customers might value. This will provide feedback on the reactions of customers themselves, which in turn can inform the actions of network companies and regulators.

How this discovery process is best achieved is not yet clear. There is no single prototype, but examples are beginning to emerge. In the UK, Ofgem's regulation of the gas and electricity networks is associating monetary rewards and penalties with the extent to which quality of service indicators are exceeded. In Florida, the Office of Public Counsel has negotiated some innovative agreements with network companies that have subsequently been approved by the regulatory commission.

In Australia, ENERGEX and other companies have proposed the concept of price-service offerings, whereby customers choose among alternatives offered by the company. I have elsewhere commented on this proposal, and suggested that it deserves very serious consideration.[1]

To further this aim of discovering the needs of customers, the objectives of the gas access legislation might usefully be supplemented by some reference to stimulating innovation by network owners, and to their discovering and meeting the needs of network users.

Conclusion

The Gas Access Regime reflects some successful developments in regulatory policy. These have increased efficiency in the operation of existing networks and pipelines, and facilitated competition across them. However, there is more that can be achieved. One of the tasks ahead is to ensure that new networks and pipelines are developed whenever and wherever they are required. This means avoiding unnecessary regulation in circumstances where such regulation is counterproductive.

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[1] ENERGEX, Submission to the Queensland Competition Authority: Discussion Paper on the Review of the Form of Regulation of Electricity Distribution. December 2002. Attachment 7: Critique of Price-service Offerings by Professor Littlechild.

Another task is to encourage innovation and the discovery of customer preferences in the provision of services related to these networks. To secure continuing improvements for customers, the nature of regulation needs to evolve as well as the nature of the industry.

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