Gas Access Regime Inquiry
Productivity Commission
LB2 Collins Street East
MELBOURNE VIC 8003

Dear Sirs

1. Review of the Gas Access Regime

4 September 2003

The Australian Gas Light Company (AGL) welcomes the opportunity to contribute to this review.

The AGL group is a leading owner and operator of gas and electricity infrastructure throughout Australia. It owns and operates natural gas distribution networks in New South Wales, electricity networks in Victoria and power generation interests in New South Wales, Victoria and South Australia, has interests in transmission, and provides services to infrastructure owners.

AGL welcomes the decisions of the Ministerial Council on Energy at its 1 August meeting that have reinforced the policy direction required to improve the environment for new investment in the energy sector, have recognised the national importance of gas supply in the national energy framework and committed to further increase the penetration of natural gas, lower energy costs and improve energy services, particularly in regional Australia.

This review provides an opportunity to consider whether the current Gas Access Regime delivers on these policy objectives.

Delivery of these policy objectives requires predictable and appropriate regulatory outcomes. Regulation must encourage efficient investment and where discretion is retained, ensure that, as far as possible, it is exercised with certainty and predicability, consistent with policy objectives.

AGL acknowledges the significant work involved in the reforms to the energy market over the last 10 years and the benefits arising from those reforms. However, AGL remains of the view that the current access regime is flawed. The absence of clear and specific rules confronts investors with many degrees of regulatory risk at both the project proposal stage and during the life of an established project.

To achieve Governments' clearly stated policy objectives, the outcome should be the implementation of a set of regulatory arrangements that will improve economic efficiency through time and will reduce some of the larger risks of making regulatory errors. The amendments necessary to achieve this can be grouped into five key themes, namely:

- Improving access regulation – reduce uncertainty about the investment environment by making clear that the policy objective is to encourage economically efficient investment in and use of pipelines, by giving more specific guidance for the exercise of regulatory discretion, and improving appeal rights;

- Introducing/improving incentives for investment in new developments;
- Coverage – pipelines should only be regulated where this will lead to a “substantial increase” in competition;
- Governance of the regime – improving the Gas Code change process; and
- Other amendments – improvements to the provisions regarding associate contracts and amendments to make clear that certain sections of the Gas Code only apply in the transmission context.

AGL’s submission addresses each of these five themes in more detail.

AGL confirms that the attached submission may be published on the Commission’s website.

Yours sincerely

Robert Wiles
General Manager
Regulation and Policy

The Australian Gas Light Company

ABN 95 052 167 405

Submission to the Productivity Commission
Review of the Gas Access Regime

September 2003

The Australian Gas Light Company

Submission to the Productivity Commission
Review of the Gas Access Regime

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2. INTRODUCTION

The Australian Gas Light Company (AGL) welcomes the opportunity to contribute to the Productivity Commission's review of the Gas Access Regime. AGL owns and operates gas distribution networks and has a minority interest in and operates gas transmission pipelines that are governed by the National Third Party Access Code for Natural Gas Pipeline Systems (the Gas Code). Through its retail and gas fired power generation interests, AGL is also a substantial user of infrastructure. AGL is therefore well placed to contribute to this review as it can draw on its experience as owner, operator/service provider and user under both the current and prior regimes.

AGL welcomes the recent announcement by the Ministerial Council on Energy (MCE) announcement of a comprehensive reform program that "*will clear the way for new investment in the national energy market.*"[1]

AGL notes the statement from the Acting Industry Minister Joe Hockey that "*The Commonwealth, States and Territories are all committed to improving the environment for new investment in the energy sector. We have all worked together to develop this reform program to increase certainty for investment and achieve a better and more efficient energy market for consumers*".[2]

There is now reinforcement of the policy direction from Governments that effort is required to improve the environment for new investment in the energy sector, a recognition of the national importance of gas supply in the national energy framework and a commitment to further increase the penetration of natural gas, lower energy costs and improve energy services, particularly in regional Australia.[3] AGL looks to the Council of Australian Governments (CoAG) to reinforce this policy direction.

This review provides an opportunity to consider whether the current Gas Access Regime delivers on these policy objectives.

To deliver on these policy objectives, predictable and appropriate regulatory outcomes are required. Regulation must encourage efficient investment and where discretion is retained, ensure that, as far as possible, it is exercised with certainty and predicability, consistent with policy objectives.

While AGL acknowledges the significant work involved in the reforms to the energy market over the last 10 years and the benefits arising from those reforms, AGL remains of the view that the present access regime is flawed. In our response to the CoAG Energy Markets Review Issues Paper (EMR Issues Paper), we submitted that the Gas Code, through the absence of clear and specific rules, confronts investors with many degrees of regulatory risk both at the project proposal stage and during the life of an established project.[4] Our view has not subsequently changed.

1 Media Release dated 4 August 2002 from Joe Hockey "Way cleared for National Energy Investment"
2 Media Release dated 4 August 2002 from Joe Hockey "Way cleared for National Energy Investment"
3 MCE Communique – Sydney, 1 August 2003
4 Page 1- AGL Response to the Energy Markets Review Issues Paper

This has significant consequences for end users. Household and business users are likely to be worse off with inadequate essential infrastructure and unreliable service than if appropriate services are provided at higher cost.

Accordingly, to deliver on the clear policy objectives of Governments, there is a pressing need to "*rebalance the current emphasis away from achieving immediate gains for users and consumers of existing infrastructure [through lower prices] …, to regulation that will also facilitate efficient investment in augmented and new facilities*"[5].

It is well recognised that there is still considerable work to be done to ensure the benefits achieved thus far by the 1990s gas reforms are not lost and the long term economic welfare of all Australians is promoted.

Productivity Commission

The Productivity Commission's review of the National Access Regime contains important findings and recommendations about access regulation, which are relevant to the industry specific Gas Access Regime. The Commission identified considerable scope for reform; the paramount concern being the potential for access regulation to deter investment in essential infrastructure.[6] The Commission proposed a range of modifications to the architecture of Part IIIA of the Trade Practices Act 1974 (Cth) (the TPA) ensure that access regulation is better targeted and more workable. These included:

- insertion of an objects clause and pricing principles to guide regulators and industry and discourage unwarranted divergence across industry-specific regimes;
- enhancing the prospects for negotiated outcomes and ultimately effective arbitrations;
- improving administrative efficiency and transparency to address the currently cumbersome and protracted arrangements;
- strengthening the coverage criteria to ensure mandated access would only occur where it would promote a substantial increase in competition; and
- streamlining coverage criteria applying across the regime's different access routes to reduce the scope for inconsistent determinations.[7]

The Government has subsequently provided an interim response.

AGL shares the concerns of the Productivity Commission, considers that many of the conclusions reached by the Productivity Commission are relevant in the gas context and, in broad terms, welcomes the Government's interim response.

Energy Markets Review

The Energy Markets Review (EMR) considered both gas and electricity and reported that while much had been achieved since CoAG agreed to establish a national energy market and that there had been benefits, it seems clear that serious deficiencies remain in some of the reform areas.[8] The Review found that these deficiencies are either areas that still need to be addressed or have emerged as unintended consequences of the recent reforms. The Review

[5] Productivity Commission Annual Report 2000/01 page 16
[6] Page XII – Productivity Commission Inquiry Report – Review of the National Access Regime
[7] Page XII – Productivity Commission Inquiry Report – Review of the National Access Regime
[8] Page 8 – "Towards a Truly National and Efficient Energy Market" - Final Report of the CoAG Energy Market Review – December 2002

concluded "*it is clear that important steps need to be taken to achieve a truly national and efficient energy market*".[9]

The Review found that the recent gas reforms had been effective, but that the gas market remains an emerging market and that there is clear benefit in facilitating the move to a more mature gas commodity market with many players and an active short term market. It found that key barriers to moving to an active gas commodity market include too much uncertainty surrounding new pipeline development and lack of effective mechanisms to ensure significant uncovered pipelines not covered by the Gas Code are operated in a way that will facilitate effective competition. Key findings, within the scope of this current review, are that additional certainty should be provided for new pipeline developments, tradeable capacity and other mechanisms should be introduced on new and unregulated pipelines, and there should be a review of the Gas Code to judge its effectiveness from both a gas industry and user perspective.[10]

AGL urges that the findings of the Commission in the review of the National Access Regime that are relevant in the context of the Gas Access Regime are used as a basis in this review so as to have consistency between the generic Part IIIA framework and the Gas Access Regime. AGL also considers that the significant work done by the EMR should be acknowledged and the findings relating to gas within scope of the current review should be used as a basis for the current review.

To achieve Governments' clearly stated policy objectives, the outcome should be the implementation of a set of regulatory arrangements that will improve economic efficiency through time and will reduce some of the larger risks of making regulatory errors. The amendments necessary to achieve this can be grouped into five key themes, namely:

- Improving access regulation – reduce uncertainty about the investment environment by making clear that the policy objective is to encourage economically efficient investment in and use of pipelines, by giving more specific guidance for the exercise of regulatory discretion and improving appeal rights;
- Introducing/improving incentives for investment in new developments;
- Coverage – pipelines should only be regulated where this will lead to a "substantial increase" in competition;
- Governance of the regime – improving the Gas Code change process; and
- Other amendments –recognising the effectiveness of ring fencing arrangements, improvements to the provisions regarding associate contracts and amendments to make clear that certain sections of the Gas Code only apply in the transmission context.

9 Page 8 - "Towards a Truly National and Efficient Energy Market" - Final Report of the CoAG Energy Market Review – December 2002

10 Pages 35-37 – "Towards a Truly National and Efficient Energy Market" - Final Report of the CoAG Energy Market Review – December 2002

3. BENEFITS AND COSTS OF EXISTING REGIME

The current Gas Access Regime is a product of the reforms which followed the publication of the Hilmer Committee's report in 1993. The Hilmer report observed that owners of bottleneck or essential facilities, particularly where they are vertically integrated with potentially competitive activities in upstream or downstream markets, have the incentive and power to restrict access to their facilities thereby inhibiting competition in those upstream and downstream markets. The conclusion was that significant benefits could be unlocked for the economy and the community if upstream and downstream markets were opened to competition, and that a pre-requisite for this to occur was that participants in those markets should have a right of access to essential facilities.

Implementation of the Hilmer reforms resulted in an access regime that applies where there exist ‘bottleneck’ or essential services facilities which cannot be economically duplicated and which must be shared by participants in competitive or potentially competitive upstream or downstream markets. The regime reflects the expectation of society, which AGL accepts, that there should be some system of controls and incentives to ensure that services are provided efficiently and to curb the exercise of monopoly power.

The two main achievements of the regime have been to provide open access for all parties to gas transportation services and to require regulatory review of access tariffs.

The access regime is just one component of a broader package of policy initiatives developed by Governments and industry to ensure efficient delivery of gas to homes and businesses. The development of competitive markets both upstream (wholesale) and downstream (retail) is also critical. The design of the access regime is an important condition for the emergence of wholesale and retail markets, but Governments have recognised that specific initiatives are needed to introduce competition both upstream and downstream. An access regime alone cannot be expected to deliver effective competition. Therefore the presence or otherwise of competitive activity in upstream and downstream markets is not a good indicator of the success of the access regime. It needs to be recognised that there are a number of historical, geographical and geological features of the Australian gas markets that have impacted on competitive activity, particularly in the upstream sector, and these factors will continue to affect the rate at which the markets develop. These considerations need to be taken into account in establishing realistic objectives for the access regime.

As drafted, the pricing provisions in the existing regime seek to establish a balance between the short and long term interests of users on the one hand and those of owners and investors on the other. The pricing provisions confer considerable discretion on regulators in key areas, and the regulators’ focus in implementing the regime to date has been on reducing tariffs. This has been achieved through a forensic examination of asset values, rates of return and operating costs. As a result, cross subsidies and other costs have been removed and passed on to consumers in significantly lower prices so that, in the case of AGL’s gas distribution networks in New South Wales, average contract market prices are now about 35% of their 1996/97 levels in real terms.

The Regulatory regime establishes the rules which determine the behaviour of the owners of essential infrastructure. The result of the regulators' focus under the current regime on reducing costs and the avoidance of monopoly rents is that owners have been focussed on reducing costs. The approach has enabled the regime to deliver some quite substantial price reductions. But, now that most infrastructure assets have been through one if not two review cycles, the question arises whether further price reductions are achievable and if so, whether they are consistent with economically efficient outcomes.

The only certain outcome for society and the economy from a continuation of the current approach will be the knowledge that monopoly rents have been avoided. In the absence of adequate incentives and rewards, the most likely result of continuing with current practice will be under-investment, leading to reduced service and unmet demand in the longer term. AGL has direct experience of such a sequence with the run down of its gas network which occurred over several decades from the 1950s. In that case, the gross margins available in the business were squeezed by increasing input costs and Government constraints on retail prices with the result that it was not viable to maintain a long-term perspective on the condition of the network. Prior to the introduction of natural gas, this customer base was shrinking, investment in the network declined, and many suburbs of Sydney did not have gas pipelines installed at the time they were developed. While the consequences of reduced investment in the gas networks are not immediate, by the 1980s, AGL faced the decision of whether to rehabilitate or abandon the assets. By that stage, AGL was able to justify a major reinvestment program on the strength of a rapidly growing gas market for natural gas. It would not be in the interests of customers or investors if a repeat of this cycle of under-investment were to be triggered by an overly onerous regulatory regime.

The social and economic effects of under-investment and over-investment are not symmetrical – the medium to long term social costs of under-investment (through reduced service and unmet demand) if prices are set too low, are greater than the costs of setting prices too high. The likelihood of these longer term consequences of current practice have been accepted by the Commission in its review of the National Access Regime and indirectly by the Government in its interim response to the Commission's findings and in-principle acceptance of the need for an objects clause.

There is also now reinforcement of the policy direction from Governments that there is a need to take steps to improve the environment for new investment in the energy sector, a recognition of the national importance of gas supply in the national energy framework and a commitment to further increase the penetration of natural gas, lower energy costs and improve energy services, particularly in regional Australia.[11]

In summary, the existing regime has allowed regulators to deliver reduced tariffs to existing customers, but at the cost of removing incentives for owners to invest in infrastructure. A continued focus on reducing prices is not compatible with the policy direction of increasing penetration in the natural gas market. AGL submits that the time is right for a change in emphasis away from the current information intensive and forensic search by regulators for illusory efficient costs, to a system which encourages investors themselves to uncover the efficiencies inherent in their operations. From an investor's point of view, the most effective incentive to pursue efficiencies would be an assurance that the investor will share in all actual efficiency gains (relative to today's level of costs) with the benefit of realised gains being passed through to consumers over time.

[11] MCE Communique – Sydney, 1 August 2003

Not only is this approach the one most likely to ensure the long term provision of infrastructure services, but it is also a prerequisite for the realisation of further efficiency gains.

4. AMENDMENTS TO THE CURRENT REGIME

In AGL's view, the amendments needed to the current national access regime fall into five groups, namely:

- Improving access regulation – Currently, the regime does not provide appropriate guidance about policy objectives, in particular about the need to ensure appropriate incentives. Regulators are currently given too much discretion and have tended to simply seek to achieve the lowest price to consumers. What is needed is clear and appropriate objectives and pricing principles that guide regulators to provide incentives for efficient investment in and use of pipelines. In addition, strengthening appeal rights will improve the nature of regulation by increasing transparency and accountability;

- Provision of specific provisions in the regime to encourage investment in new developments;

- Coverage – pipelines should only be regulated where this will lead to a "substantial increase" in competition;

- Governance – the Gas Code change process will need to change in line with the recent announcement by the MCE; and

- Other amendments - improvements to the provisions regarding associate contracts and amendments to make clear that certain sections of the Gas Code only apply in the transmission context.

3.1 Improving access regulation – inclusion of appropriate objectives and pricing principles and improving appeal rights

AGL is concerned with the operation and effect of the current regime. The guidance in the Gas Code given to regulators about the policy objectives does not provide sufficient or appropriate direction to regulators. The lack of clear and appropriate guidance together with the wide discretion available to regulators results in significant uncertainty about regulatory outcomes. Moreover, in the absence of appropriate direction, the discretion of the regulators has tended to be applied so as to ensure short term benefits (ie the lowest price) for consumers.

The effect of this lack of guidance has been:

- To reduce the expected returns from investment with the end result that the owners of regulated assets have become increasingly reluctant to invest in regulated assets. In AGL's case, the direction taken by regulators has led it to increasingly scrutinise its spending and to actively pursue and take up alternative investment opportunities;

- That regulators' focus on forecasting efficient outcomes for the next five years. The result has been that regulation has become extremely intrusive and costly, and worse, has removed strong incentives for service providers to seek out more efficient ways of operating and maintaining their networks.

Each of these outcomes is considered in more detail below.

Alternative investment opportunities

AGL has a number of options as to where to invest and indeed has diversified its portfolio, in part, due to the risk and uncertainty associated with the current regulatory regime. For example, in the last decade AGL has transformed itself from a largely NSW based gas utility company with a range of diversified investments in the energy industry. AGL now has the choice of investing funds in both regulated and unregulated businesses across both the electricity and gas industries in Australia or overseas. For AGL to choose to invest further funds in the regulated Australian gas infrastructure, there needs to be an appropriate balance of risk and return.

Within the regulated gas business, AGL has a large amount of discretion as to the level of investment it makes. AGL's annual investment in networks is made up of:

- discretionary growth capital expenditure which is driven by economic decisions. This includes connecting new customers within existing areas or in new extensions at the margins of existing networks. As gas is not an essential fuel, and competes with other energy sources, such investment will only continue given the right regulatory environment; and

- system augmentation and replacement which requires judgement in determining when investments are necessary to maintain the appropriate level of service to meet the growth in market demand. As the current Code imposes greater risks for such investments, the tendency will be to exercise judgements which will reduce the impact of regulatory risk. It becomes increasingly likely these judgements will result in decisions which are not in the long term interests of gas users.

The current regime means there is a real risk that efficient investments in current networks and in future development will be deferred.

Efficient outcomes

Currently, the Gas Code requires regulators to determine efficient costs. In reaching decisions about appropriate costs in access arrangements, regulators are required to determine the current level of efficient costs and then forecast those costs for five years ahead. In addition, they are required to determine the prudency of capital investment in a network and the operating costs of a network. They are also required to make judgements as to the fair and reasonable allocation of costs and revenues applicable to groups of customers and services.

It is well recognised that the determination of efficient costs is a difficult and imprecise exercise and in AGL's opinion, the business is best placed to make judgements about the efficient operation of the business. Experience has demonstrated just how difficult and time intensive it can be for regulators to try to determine efficient costs. Regulators have undertaken detailed forensic analysis of investments, maintenance and operating activities, throughput forecasts and cost allocations. Information gathering necessary to support such analysis is intensive and costly for both the Service Provider and regulator, often involving use of consultants to advise regulators. AGL has now participated in three gas Access Arrangement reviews (two for NSW and one for the ACT). During these reviews, it has been required to spend considerable time and effort in providing large amounts of information in response to a number of requests. However, rather than providing incentives for investment, the approach requiring regulators to determine efficient costs has simply resulted in inefficient outcomes and management focus on regulation rather than on innovation and efficient operations.

While AGL accepts the need for access regulation for covered infrastructure, AGL does not consider that the current style of regulation contained in the Gas Code is either appropriate or delivers benefits for customers. It imposes significant costs of compliance and lessens incentives for management to invest in gas networks and pipelines which deliver long term benefits to the community and seek innovative ways of looking for efficiency.

AGL considers that, in large part, this situation is a direct result of a lack of clear and appropriate guidance given to regulators about the overall objectives of the an access regime. It is important to establish up front what regulation is meant to achieve. That way, regulators, regulated businesses, investors, and end users understand the purpose of the regime and can make informed decisions.

The regime would be significantly improved by including clear and appropriate objectives and appropriate pricing principles. It should be made clear that the objectives are paramount and these should be reflected in the Gas Code and legislation.

3.1.1 Clear and appropriate objectives

The Terms of Reference direct the Commission to identify any necessary improvements to the Gas Access Regime in terms of its objectives.

In its Issues Paper, the Commission raises a number of questions regarding the objectives. AGL considers that a number of improvements are necessary in terms of the Gas Access Regime's objectives.

AGL welcomes the in principle agreement of the Government to the Productivity Commission recommendation that an objects clause be inserted into Part IIIA of the Trade Practices Act and that the decision maker should be required to have regard to that clause.[12]

AGL agrees with the Government that an objects clause in Part IIIA would provide greater certainty for infrastructure owners, access seekers, investors and other interested parties. AGL agrees with the Commission that it should provide greater certainty to service providers and access seekers about the circumstances in which intervention may be warranted, emphasise, as a threshold issue, the need for the application of the regime to give proper regard to investment issues, promote

[12] Interim Government Response to the Productivity Commission Report on the Review of the National Access Regime

consistency in the application of the regime by various decision makers, and help to ensure that decision makers are accountable for their actions.[13]

As set out in section 3.1 above, AGL considers that there is inadequate and inappropriate guidance given to regulators and that this has created uncertainty. To reduce uncertainty, appropriate objectives should be set out. It is important to make it clear that the objectives are paramount. These objectives should be reflected in the Gas Code and the legislation.

The Gas Access Regime currently contains a number of objects type clauses. The 1997 Natural Gas Pipelines Agreement (NGPAA) sets out the objectives of the Regime and these are reiterated in the preamble to the Gas Pipelines Access Act (GPAA) and the introduction to the Gas Code. However, the statement of objectives contains multiple objectives cast in very wide terms and does not provide sufficient guidance to regulators. More importantly, it does not reflect the objectives proposed by the Commission in the Review of the National Access Regime, which were recognised as being essential improvements to the national regime and which should be reflected, where possible, in industry regimes. AGL suggests that, for consistency across access regimes, it is essential to amend the objectives in the NGPAA, the GPAA and the Gas Code along the lines recommended by the Commission, making it clear that one set of objectives is paramount.

Crucially, the current objectives and principles contained in various parts of the Gas Code conflict and there is no overarching guidance given to regulators as to which objectives should have priority and what weight should be given to various objectives. For example, no meaningful guidance is given as to how the non binding objectives fit with sections 2.24 and 8.1 of the Gas Code, what principles are necessary and what priority should be accorded to the various principles. The numerous objectives, some of which conflict, mean there has been a lack of clear guidance with the effect that there has been uncertainty and a lack of clarity for regulated businesses and existing and potential users. It has also resulted in increasingly intrusive regulation.

In addition, regulators have tended to seek outcomes which would presumably be found in perfectly competitive markets. This has resulted in an approach that allowable revenue from access prices should be just sufficient to ensure continued service provision.

In the decision of Western Australian Supreme Court in the Epic Energy Case, an approach of “workable competition” was recognised.

AGL considers that the regime should provide guidance to regulators that they do not need to, and in fact, should not be, seeking to reproduce perfectly competitive outcomes.

[13] Page XXII – Inquiry Report into the National Access Regime.

Recommendation 3.1
AGL recommends that, to ensure consistency between the generic Part IIIA regime and the Gas Access Regime, it is essential to adopt an appropriate objects clause along the lines recommended by the Commission in the National Access Regime Review, referring to the need to promote the economically efficient use of, and investment in, essential infrastructure services.

AGL also considers that there should be reference to the standard of workable competition.

It should be made clear that these objectives are paramount and these objectives should be reflected in the Gas Code and the legislation.

A suggested amended version of appropriate objectives is:

"The objective of the Gas Code is to promote the economically efficient use of, and investment in gas pipelines, consistent with that which would occur in a workably competitive market. Consistent with that objective the Gas Code is intended to:

- provide a consistent national framework of third party access to natural gas pipelines, including provision of rights of access to natural gas pipelines on conditions that balance the short term and long term interests of Service Providers and Users;
- facilitate the development and operation of competitive wholesale and retail markets for natural gas in which customers may choose suppliers, including producers, retailers and traders;
- prevent abuse of monopoly power; and
- provide a framework for the resolution of disputes."

3.1.2 Access pricing

Pricing principles

The Terms of Reference require the Commission to identify and investigate the appropriateness of including in the Gas Code minimum (price and non price) requirements by which pipeline and/or network owners and operators can provide a fully competitive, open and transparent third party access service on a non-discriminatory and economically efficient basis to users.[14]

The Issues Paper contains a number of queries relating to Reference Tariffs. In particular, the Issues Paper asks whether the reference tariff objectives specified in the Gas Code are appropriate and if not, what improvements could be made. The Issues Paper also asks whether the multiple objectives assigned to reference tariffs and the discretion regulators have to make trade-offs between them lead to any problems.[15]

[14] Page 25 - Productivity Commission Review of the Gas Access Regime Issues Paper July 2003
[15] Page 27 - Productivity Commission Review of the Gas Access Regime Issues Paper July 2003

AGL submits that there are a number of significant issues with the pricing principles that are used to determine Reference Tariffs. The key issue is that there is no clear specification of objectives.

As the Commission has pointed out in its report on the National Access Regime, clear specification of objectives is fundamental to all regulation.[16]

AGL repeats the comments made in its response to the EMR Issues Paper that infrastructure investment is vital to economic growth and welfare, infrastructure services are capital intensive which means that the investment climate for infrastructure is particularly important and access regulation is perhaps the most critical factor impacting on the investment climate for infrastructure. Therefore, it is of national importance that access regulation provides correct signals for infrastructure development.[17]

The Productivity Commission recommended inclusion of pricing principles in Part IIIA as this would:

- "condition negotiations between service providers and access seekers and thereby increase the likelihood of negotiated outcomes;
- indicate how the broad objectives of Part IIIA should be reflected in regulatory determinations under the regime; and
- assist in the development of pricing frameworks in industry regimes".[18]

The Commission also found that they would:

- provide better guidance on how the broad objectives of access regimes should be applied in setting more detailed terms and conditions;
- provide a measure of certainty to regulated firms and access seekers (improving the operation of the negotiation/arbitration framework);
- provide guidance for pricing principles and/or approaches in industry regimes; and
- help address concerns that regulators own values will unduly influence decisions relating to the terms and conditions of access.[19]

AGL welcomes the interim response of the Government agreeing that statutory pricing principles should be established in relation to Part IIIA. AGL's own experience is that the current pricing principles are confusing and provide too much discretion to the regulator. For example, the Gas Code allows regulators significant discretion in relation to the determination of the Initial Capital Base. In determining the initial capital base for the NSW Gas Networks, IPART was required to decide a value that would normally fall between the depreciated actual cost ($1.0b) and the depreciated optimised replacement cost (feasibly up to $3.3b).

At present, AGL does not consider that the current regime provides clear guidance to the regulators about what pricing is meant to achieve. Regulators have been left to

[16] Page XXII Inquiry Report – Review of National Access Regime
[17] Pages 1 and 2 – AGL Response to the Energy Markets Review Issues Paper
[18] Page XXIII Inquiry Report – Review of National Access Regime
[19] Page 143 - Inquiry Report – Review of National Access Regime

determine whether pricing should be about achieving the lowest possible price or some other outcome.

As set out in section 3.1 above, the effect of the current application of the regime has been to cause regulated entities to become increasingly wary of further investment in regulated assets. As discussed above, this is due in large part to the apparent tendency for regulators to simply seek to achieve the lowest possible price for consumers. In the case of AGL, the direction taken by regulators has led it increasingly to scrutinise its spending and to seek to diversify its portfolio in order to address the risk of an uncertain regulatory environment.

For the reasons set out above, pricing principles should be introduced into the Gas Code. As the Government indicates in its interim response to the National Access Regime, this will contribute to consistent and transparent regulatory outcomes, provide certainty for investors and access seekers and facilitate commercial negotiations.

However, it is critical that the pricing principles are appropriate. As the Commission noted in the Review of the National Access Regime, a "*key requirement in the Commission's suggested principles is that pricing determinations under Part IIIA should provide a sufficient return to service providers to justify continuing investment in the infrastructure concerned. The principles also endorse the use of multi-part pricing arrangements and the provision of incentives within pricing determinations for service providers to improve the efficiency of their operations*".[20]

While the Commission did not go into a lot of detail regarding pricing principles at an industry specific level, it did provide guidance on the matters that should be taken into account when setting pricing principles.

AGL submitted in its response to the EMR Issues Paper that it had identified at least seven sources of uncertainty.[21] AGL continues to be concerned about these seven sources of uncertainty which are listed below.

(i) Uncertainty regarding the initial regulatory rate of return for new infrastructure and uncertainty as to whether the rate for successful investments will be subsequently reduced.

(ii) Uncertainty as to whether the regulator will, in future price determinations, reduce the risk component of the rate of return for successful investments from the figure set initially.

(iii) Uncertainty as to whether actual capital expenditure on additions will be allowable in price determinations or whether part will be deemed imprudent; and as to whether an investment deemed prudent at the time of investment will in future be deemed redundant, in whole or in part.

[20] Page XXIII Inquiry Report – Review of National Access Regime
[21] Page 5 – AGL Response to the Energy Markets Review Issues Paper

(iv) Uncertainty as to whether benefits from taxation investment incentives will be removed through regulatory price determinations after the investment has been made.

(v) Uncertainty as to whether actual operating costs incurred by an efficient operator will be recoverable in regulated prices.

(vi) Uncertainty as to how efficiencies will be treated, and to what extent, if any, that the owner will get to share in them; and as to how shared costs will be treated, whether the owner will get to share in any realised synergies, and whether the owner will be free to allocate shared costs in an economically efficient manner.

(vii) Uncertainty as to how greenfields and regional development investments are to be treated.

Of these uncertainties, AGL, as a current owner of significant assets covered by the Gas Code, considers that the treatment of efficiency gains and the issues around recovering efficient costs are the most important. Accordingly, while the details of the seven uncertainties are set out in Appendix A, AGL considers that the treatment of efficiency gains and issues around recovering efficient costs warrant further discussion here.

Treatment of efficiencies

AGL is concerned with the current treatment of efficiencies. Incentive regulation aims for innovation by offering asset owners a share in the efficiencies that are produced. However, the current regulatory regime does not provide real incentive regulation.

The current regime sets prices on the basis of regulator forecasts of ‘efficient’ costs. This leaves investors uncertain as to whether prices will allow recovery of genuine costs for an efficient operator. Further, by setting prices on the basis of regulator estimates of forward looking ‘efficient’ costs, regulators are awarding 100 percent of what they consider to be achievable efficiencies to customers. Investors get no share in them at all. If regulators over-estimate the potential for efficiencies, then they will transfer to customers the benefits of efficiencies that cannot reasonably be realised.

Proper incentive regulation requires that only realised efficiencies be shared, and upfront certainty as to how they will be shared.

Failure to do so will mean that regulated businesses are less likely to take the risk and to innovate. AGL believes that there are further efficiency gains which can be unlocked. However, incentives to innovate and uncover further efficiencies are particularly important given the current state of the industry. The industry restructuring that followed the introduction of the current access regime involved the separation of contestable activities (retailing and supply) from the natural monopoly activities of transmission and distribution. This "first wave" of disaggregation is largely complete in Australia and, now that most monopoly assets have been subject to at least one access review, the bulk of readily achievable efficiency gains have been realised.

However, there is the potential for a second wave of disaggregation which could unlock further significant efficiency gains. It involves infrastructure owners contracting out asset management and operational services.

Infrastructure industries in Australia are on the verge of this second wave of restructuring which will involve greater contracting out of activities which are presently, and for the most part, provided in-house; principally asset management and operation services. This will lead to greater competition in the provision of those services and, compared with the alternative of independent stand-alone businesses or services, has the potential to produce significant economic efficiencies through sharing of resources and economies of scope and scale. McKinsey's have expressed a view that "the impact of this second wave of disaggregation will be at least as great as that of the first wave." [22]

If the second wave of restructuring is to proceed, the investors in those businesses must be able to foresee some reward, in terms of a share of the efficiencies created, for the costs and risks they will be incurring.

It is important that the Gas Access Regime explicitly recognises the benefit that such restructuring can provide and provides appropriate guidance to regulators. The regime should give the managers of the business an incentive to drive efficiency gains. It should also discourage regulators from setting tariffs based on the minimum level of efficient costs and allow service providers to retain a reasonable share, for a reasonable time, of the benefits of realised efficiency gains.

Recommendation 3.2

It is important that the Gas Access Regime provides clear guidance on the treatment of efficiency gains. AGL considers that an earnings sharing model is appropriate. The components of an earnings sharing model are:

(a) that a price glide path is set from today’s average price to a target average price at the end of the next regulatory period (5 years hence);

(b) the target average price is determined as the price that would (if it applied today to the most recent year’s volume sales and given the most recent year’s actual costs) result in a rate of return equal to the cost of capital. The difference between today’s price and the target price represents efficiencies realised in the last regulatory period.

(c) By gliding from today’s price to the target price, efficiencies realised in the last regulatory period are transferred to consumers progressively over the next regulatory period, and investors and consumers share in the benefits of improved efficiency.

[22] Birch D, and Burnett-Kant, E., "Unbundling the Unbundled", The McKinsey Quarterly, 2001 Number 4.

Recovering efficient costs/pricing methodologies

Recommendation 3.3
AGL considers that current access pricing methodologies are too intrusive and that regulated entities should be able to choose the access pricing approach they prefer. For example, one model which should be available to regulated entities is the "price monitoring model". AGL notes that this model has been applied in the case of airports and has also been used in New Zealand.

The public policy goal should be a set of regulatory arrangements that will improve efficiency through time, and that will reduce or avoid some of the bigger risks of making regulatory errors.

AGL welcomes the Government's response to the Commission's recommendation in the National Access Review that improved access pricing methodologies should be implemented.

The current regulatory model, especially the provision that only "efficient" costs shall be recoverable, presumes efficient costs are capable of accurate estimation by the regulator, introduces uncertainty and undermines investment confidence. Regulated entities should be left to optimise their operating costs. As an example, the level of marketing costs should be left to the service provider as it is in their interests to optimise these costs.

The level of marketing costs is of particular importance to gas distribution network businesses following the industry restructuring of the past few years. In many applications gas is a discretionary fuel (in this respect it differs from electricity) and significant effort is required to promote both its supply to newly constructed dwellings and its consumption in existing dwellings and businesses. Retailers now are generally dual fuel businesses with little interest in promoting one fuel over another; only the network owners are directly interested in promoting the use of gas. AGL's recent experience is that regulators' emphasis on minimising allowable costs has led directly to a loss of market share, a result which is in conflict with higher level policy direction of promoting the share of natural gas in the markets.

Appropriate pricing principles

AGL continues to believe that all of the identified uncertainties could be resolved by clearly stated pricing principles.

Recommendation 3.4
AGL endorses pricing principles similar to those suggested by the Productivity Commission in its review of the National Access Regime. For ease of reference, AGL has set out below the principles proposed by the Commission in its review of the National Access Regime, incorporating AGL's proposals in italics.

"The *Relevant Regulator, where it considers it necessary to seek* to reduce access prices that are inefficiently high, must … have regard to the following principles:

(a) that regulated access prices should:

(i) be set so as to generate expected revenue across a facility's regulated services that is at least sufficient to meet the efficient long-run costs of providing access to those services;

(ii) include *at least* a return on investment commensurate with the regulatory and commercial risks involved;

(iii) generate revenue from each service that at least covers the directly attributable or incremental cost of providing the service.

(b) that the access price structures should:

(i) allow multi-part pricing and price discrimination when it aids efficiency: and

(ii) not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher."

Recommendation 3.5
AGL suggests that pricing principles should make clear that

- Where the cost of capital is relevant, the variables of the weighted average cost of capital shall be determined by a panel of experts. Industry and the regulator must apply the variables which have been determined by a panel of experts;
- Where the cost of capital is relevant, the risk component shall be fixed for the life of an asset;
- Capital expenditure that is deemed prudent at the time of investment shall not be stranded at some future time;
- Where forward prices are fixed by regulation, they shall be set on the basis of actual costs and volume sales at the time of price fixing, not on the basis of forecasts; and
- Investors shall share in all realised improvements in efficiency, not only in improvements that exceed regulator benchmarks.

Recommendation 3.6
AGL submits it is important that, in addition to the high level pricing principles above, the Gas Code is amended to explicitly provide for the earnings sharing model.

3.1.3 Appeal mechanisms

The Issues Paper asks whether there is scope to improve the effectiveness and timeliness of the access arrangement process by providing for an appeal on the merits of a regulator's decision earlier in the process.

As AGL identified in its response to the EMR Issues Paper, regulatory decisions can have a very significant impact on the property rights of infrastructure owners. Accordingly, it is important that regulators are accountable for their decisions.[23]

The usual mechanism to achieve this is allowing affected parties to appeal a decision of a regulator when key decisions are made. Normally, rights of review are available in relation to the process or procedure employed in arriving at a decision and in relation to the merits of the decision itself. However, under the Gas Access Regime, parties have limited rights. They are able to review processes and correct interpretation and application of the law under the Administrative Decisions (Judicial Review) Act and have a right of review of the merits of a decision. However, they are not able to seek merits review of a decision until the conclusion of the process.

Typically, regulatory decisions under the Gas Access Regime involve a number of steps.

- Where a pipeline is covered, the Service Provider must establish an Access Arrangement to the satisfaction of the Relevant Regulator ("the regulator").
- An Access Arrangement (together with Access Arrangement Information) must be submitted to the regulator for approval.
- The regulator may require the Service Provider to amend and resubmit the Access Arrangement Information.
- Submissions are called for.
- Following consideration of submissions, the regulator issues a Draft Decision;
- After considering submissions received on the Draft Decision, the regulator issues a Final Decision which either approves the proposed Access Arrangement, does not approve it and sets out the revisions required before the regulator would approve it, or approves a revised Access Arrangement which incorporates amendments specified by the regulator in its Draft Decision.
- If the relevant regulator does not approve the Access Arrangement, the Service Provider may propose an amended Access Arrangement which incorporates the revisions required by the regulator. The regulator makes a Further Final decision.
- If the Service Provider does not make the changes required by the regulator, the regulator can impose its own Access Arrangement.

To date, despite the clear intention of the Gas Code that it take 6 months, approval of Access Arrangements have taken at least 12 months. While judicial review can be

[23] Page 7 – AGL Response to the Energy Markets Review Issues Paper

sought following a Draft Decision, merits review is not available until the regulator approves and issues its own decision.

Importantly, the significant discretion given to regulators limits the value of the appeal rights under the regime.

Further, in reviewing a decision, the appeal body is currently limited to consideration of the matters set out in section 39(5). The appeal body should not be so limited and should be able to consider all relevant material.

Providing guidance to regulators by inserting clear and appropriate objectives, amending the coverage test and amending the pricing principles to significantly constrain the regulators' discretion will assist in resolving the concerns about the effectiveness of appeals.

In addition, the National Gas Access Regime should be amended to address the concern that a merits review is available too late in the process.

Recommendation 3.7
There should be provision for merits review:

(i) of a Final Decision; and
(ii) of an access arrangement drafted and approved by the regulator.

The grounds of appeal for each should be the same. Amendments that are needed to the grounds of appeal are:

(a) section 39(2) of the Gas Pipelines Access Act should be deleted;
(b) section 39(5) of the Gas Pipelines Access Act should be amended to provide:

"The matters to which the relevant appeals body, in reviewing a decision made under this section, must consider are:
(a) the application for review and submissions in support of the application;
[(ab) – (f) remain unchanged];
(g) any other matter the appeals body considers relevant".

It is vital that the arbitrator is someone who is independent from the regulator's decision and who does not have an interest in the outcome.

Recommendation 3.8
AGL submits that the regime should be amended so, in relation to section 6 of the Gas Code, the regulator cannot be the arbitrator.

3.2 Incentives for investment in greenfield developments

The Terms of Reference direct the Commission to identify any necessary improvements to the Gas Access Regime, in particular the Gas Access Code, in terms of its effect on investment in transmission pipelines and distribution networks, including the operation of those parts of the Gas Code dealing with the tender process, ring fencing, information gathering and expansions/extensions of pipelines and networks.

The issue of facilitating efficient new investment has been raised as one of importance by both the Commission in its review of the National Access Regime and by the EMR.

The Commission's recommendations were that there should be the ability to seek binding rulings and that mechanisms should be refined to facilitate efficient investment.[24] The Government indicated that it proposed to consider this recommendation in the context of industry specific regimes.

The EMR found that while the recent gas reforms had been effective, "there is clear benefit in facilitating the move to a more mature gas commodity market with many players and an active short term market."[25] The EMR found that there were a number of barriers to moving towards an active gas commodity markets and that one of these barriers was uncertainty over the regulatory treatment of new pipelines. AGL agrees with this view.

The EMR found that the uncertainty was twofold: project proponents are unable to gain a binding decision on whether a new pipeline will be covered by the Gas Code during the life of the project; and there was uncertainty as to how regulators would interpret critical Gas Code components such as future access pricing if the project was covered. The Review found that this all adds to the risk which, at the margin, could reduce the number of pipelines built.

The EMR suggested the following:

- Allowing binding rulings from the National Energy Regulator on coverage under the Gas Code prior to construction, with applicants able to propose the duration of such rulings;[26]
- A 15 year economic regulation free period, provided there is a commitment to provide access, publish tariffs, make all contracted capacity tradeable and have sufficient vertical separation of ownership;[27] or
- Upfront agreement with the National Energy Regulator prior to construction that locks in a number of key regulatory parameters for an extended time period.[28]

AGL shares the view of both the Commission and the EMR that there is currently too much regulatory uncertainty facing the proponents of new pipeline development. AGL considers that the Gas Code does not currently contain effective incentive mechanisms or that there are other viable options to address concerns about truncation

24 Pages XXV and XXVI - Inquiry Report – Review of National Access Regime

25 Page 35 – "Towards a Truly National and Efficient Energy Market" - Final Report of the CoAG Energy Market Review – December 2002

26 Recommendation 7.1 - "Towards a Truly National and Efficient Energy Market" - Final Report of the CoAG Energy Market Review – December 2002

27 Recommendation 7.2 - "Towards a Truly National and Efficient Energy Market" - Final Report of the CoAG Energy Market Review – December 2002

28 Recommendation 7.3 - "Towards a Truly National and Efficient Energy Market" - Final Report of the CoAG Energy Market Review – December 2002

of investment returns. As the Commission's issues paper points out, notwithstanding these mechanisms, the EMR considered it necessary to recommend changes to the Gas Code to address concerns about its impact on investment.[29]

AGL welcomes the recommendations made by the Commission and the EMR, but repeats the comments made in its response to the Draft Report of the EMR.[30] In short, AGL considers that:

- The introduction of binding up-front coverage rulings will substantially remove the element of regulatory uncertainty for greenfields pipelines, particularly marginal projects;
- a holiday of 20 years would be more appropriate as most pipeline projects are evaluated using at least a 20 year evaluation period and that distribution network expansions should also attract these provisions;
- the recommendation for up front regulatory agreements is superficially attractive, but that changes are needed to the Gas Code to give stronger guidance to regulators in the exercise of their discretion. This recommendation should also apply to distribution networks.

In addition to those comments, AGL believes that other options need to be considered. In particular, AGL submits that consideration should be given to the ability to have exclusive franchises for a predetermined time period and to an NPV benefit sharing model. These are discussed in more detail below.

Exclusive franchises

AGL's experience with the Gas Access Regime demonstrates the potentially chilling effect that the regime has had on greenfields investment in both transmission and distribution. AGL is able to draw on its experience with greenfields investment prior to the implementation of the Gas Access Regime and to contrast this with its experience under the current regime. An example of AGL's experience in this area is set out below.

AGL invested in two major projects to extend gas supply to regional areas in New South Wales. Prior to the introduction of the Gas Access Regime, AGL extended gas supply to the Riverina. AGL also extended gas supply to the Central West of New South Wales. The latter extension began shortly before the introduction of the Gas Access Regime but was substantially completed following the introduction of the Regime.

The level of gas penetration achieved in the Central West was much lower than the level of gas penetration achieved in the Riverina. AGL attributes this, in large part, to the changes in the regime. At the time the Riverina project was developed and implemented, retail and distribution were not separated. This meant that retail and distribution were easily able to work together to develop the market and to react to changes in the market as the project developed. In contrast, the Central West project was essentially developed and implemented while retail and distribution were

[29] Page 22 – Productivity Commission Review of the Gas Access Regime Issues Paper July 2003
[30] AGL response to CoAG Energy Market Review Draft Report (dated 6 December 2002)

separated. This made the project much more difficult, particularly in relation to reacting to changes in the market and to driving demand.

A portion of the margin that would previously been used by an asset owner to justify a targeted level of return on its investment is now earned by various retailers, thus making it more difficult for asset owners to justify new developments, both to shareholders and to regulators.

The reality is that greenfields developments are often marginal and to make these projects viable the retailer and the distributor must work together to market the project. Generally, greenfields developments require fairly aggressive marketing as it is necessary to compete with an incumbent fuel source and to attract demand. It is essentially the marketing that determines whether the project will be successful. This is driven by the retail business. Separating retail and distribution makes greenfields projects significantly more difficult. The current regime fails to recognise the difficulties associated with greenfields development and fails to facilitate greenfields investment.

If the policy objective is to increase natural gas penetration and further greenfields developments are desired, then it is necessary to facilitate such development.

Recommendation 3.9
AGL considers that providing long term exclusive franchises for a pre-determined time period would greatly assist the viability of greenfields distribution and facilitate new investment.

NPV benefit sharing model

Much has been said about the truncation of returns and regulatory uncertainty that presently detract from the viability of investments in greenfield projects. It is important to take into account the fact that gas transmission and distribution assets are long lived assets which require 20 or 30 year cash flows (or even longer) to attain attractive returns.

Greenfield projects inevitably rely for their viability on highly uncertain projections of market growth. A prior assessment of an investment opportunity will take into account a range of possible scenarios from unsuccessful to successful. A rational investor will proceed only if the probability weighted return from those outcomes is at least equal to the investor's cost of capital as assessed at the time the decision is made. In particular the investor must be confident of being able to realise and retain returns above the cost of capital if the project is successful -- a share of the "blue sky" -- to balance the likelihood of outcomes where the project is unsuccessful and fails to produce a satisfactory return.

The current regime provides no certainty that the investor will be permitted to retain anything above a cost of capital which is in turn likely to be determined on a retrospective view of the project's risk.

Fixed term access holidays of 15 to 20 years have been proposed as a solution. However, the cash flow profile of a greenfield project is generally such that it will become NPV positive only late in its life (often after 20 plus years, if at all). It is unlikely that a marginal greenfield project would become NPV positive within a period of 15 to 20 years, even if it is successful. That is, it is unlikely that the investor would see any "blue sky" within that period. While supportive of the concept of access holidays, in principle, AGL cautions that it may be of limited benefit if the holiday is simply to be followed by application of the current regulatory regime with all of its uncertainties.

The central question if access holidays are to be pursued will be the valuation to be put on the pipeline assets at the end of the holiday. This valuation will be critical to the returns to investors over the subsequent period. Further, this is likely to be the period during which investors will be expecting above-average returns from successful projects. Unless investors can be confident <u>at the time of making the initial investment</u> that regulators will recognise their claim to above-average returns should the project be successful, then the access holiday will do little to attract investment in new greenfields projects.

In AGL's view, fixed term holidays which simply apply the normal regulatory regime thereafter are a distant second best option.

Recommendation 3.10
AGL's preferred approach is to allow the performance of the project itself to determine the duration of the holiday -- the holiday would extend to the point when (if ever) the cumulative NPV of the project becomes positive. From that point onwards the "blue sky" would be shared between the investor and consumers in a pre-agreed manner. The fact that the upside of successful outcomes will be shared does reduce their economic value, but in a manner which is known to the investor: most importantly the investor is assured at the outset of a share of any "blue sky". This can be contrasted with the outcome under a fixed term holiday.

The Commission considered the NPV benefits sharing approach in the National Access Regime review and discounted it, in part because of a perception that "it would be information intensive, prone to disputation and open to gaming". (p317). Any information requirements could hardly be more onerous than those that apply under the current regulatory regime. In AGL's view, workable arrangements can be devised. For example, the offshore petroleum industry is subject to a secondary taxation regime based on similar principles (the PRRT) where the tax becomes payable only if and when cumulative NPV for a project becomes positive. That regime includes workable arrangements for provision of information. The administrative and compliance costs of the NPV approach will be small compared to its benefits if, as AGL expects, it enables greenfield projects to proceed that otherwise would not.

3.3 Coverage

The Issues Paper notes that the Terms of Reference direct the Commission to identify any necessary improvements to the Gas Access Regime in terms of its application.[31]

As the Commission points out in its Issues Paper, as access regimes have the potential to generate costs as well as benefits, it is important that their application should be limited to the special market circumstances for which they are intended.[32]

The Commission asks whether the current coverage test and its application are appropriate and if not, why and how the coverage test could be improved.[33]

AGL considers that the current coverage test and its application fail to meet the objective of only regulating pipelines where the benefits of increased competition clearly outweigh the costs to the community. In the review of the National Access Regime, the Commission identified a need to guard against inappropriate declaration of essential facilities by amending the declaration test in Part IIIA of the TPA. While the Commission noted that, for some, the recent Eastern Gas Pipeline decision had largely addressed concerns about the application of the Part IIIA declaration criteria, the Commission suggested that, to provide immediate assurance against the possibility of inappropriate declarations, the first of the declaration criteria be strengthened. The recommendation was that declaration would have to promote a substantial increase in competition in another market, rather than simply promoting competition.[34] In addition, the Commission recommended that if it is considered that the inclusion of the word substantial carries a concomitant requirement for greater certainty of outcome, an explicit concept of likelihood may need to be embodied in the revised criterion[35]. AGL supports the Commission's recommendation in relation to the declaration criteria.

In its interim response, the Government indicated that it agreed in principle with the Commission's recommendation but proposed replacing the term "substantial" with the term "material". The Government's reasoning was that access may not be made available to a small supplier if the test were to require a substantial increase in competition. AGL recognises the Government's concern that a test based on a substantial increase in competition may result in exclusion of a small supplier from access to nationally significant essential infrastructure. Balanced against this is a need to recognise that the cost of unnecessary regulation is high and will result in economic inefficiency. In AGL's view, the term "substantial" is the appropriate test. This term has been used throughout the Trade Practices Act for some years now and delivered effective competition outcomes. AGL is concerned about the possible confusion that could result from the introduction of a new term and possible cost as the term "material" is tested.

31 Page 16 - Productivity Commission Review of the Gas Access Regime Issues Paper July 2003
32 Page 16 - Productivity Commission Review of the Gas Access Regime Issues Paper July 2003
33 Page 16 - Productivity Commission Review of the Gas Access Regime Issues Paper July 2003
34 Page XXIII – Inquiry Report into the National Access Regime.
35 Page XXXIII – Inquiry Report into the National Access Regime.

The coverage criteria in the Gas Code are derived from the criteria in Part IIIA. The concerns that have been identified in relation to the "promotion of competition" test in the declaration criteria in Part IIIA also apply to the coverage criteria in the Gas Code.

AGL's firm view has been and continues to be that there is a need for common national systems for access regulation and regulatory practices.[36] AGL also believes that it is important that all Australian access regimes have tightly focussed declaration criteria.[37]

Recommendation 3.11
The Commission's recommendations in relation to the declaration criteria in Part IIIA should be applied to the coverage criteria in the Gas Code. The coverage test should be amended so that coverage would have to lead to a "substantial increase" in competition.

There are likely to be pipelines covered at present where it is demonstrable that coverage is not beneficial to the community. Applications for revocation must have regard to the coverage criteria. The cost of the revocation process, combined with the issues around the current test are likely to mean pipeline owners will not seek revocation and they will remain covered, resulting in unnecessary compliance costs. Strengthening the coverage test should provide an opportunity for the removal of inefficient regulation, ultimately providing a better result for the community.

The recommendation by the National Competition Council (NCC) to reject East Australian Pipeline Limited's (EAPL's) application for revocation of coverage of the Moomba Sydney Pipeline (MSP) is a case in point. The NCC's recommendation leads to a number of inappropriate outcomes, including:

- two pipelines (MSP and the Eastern Gas Pipeline (EGP)) which compete for the same gas transportation market, where one is regulated (MSP) and one is not (EGP).
- the unregulated pipeline has a significant information and cost advantage over the regulated pipeline as a consequence of coverage.

AGL is of the view that a stronger coverage test may have led to a different recommendation by the NCC.

AGL considers that the only change that is required in relation to coverage is to amend the coverage test to refer to a "substantial increase in competition". AGL accepts that there is some concern about significant pipelines not covered by the Code. The EMR found that currently, there was no effective mechanism to ensure that significant pipelines not covered by the Gas Code are operated in a way that will facilitate effective competition (eg appropriate ring fencing and offering tradeable capacity). AGL would be concerned, however, about any proposal to extend the coverage test.

[36] Page 3 – letter dated 19 April 2002 from AGL to Energy Market Review
[37] Page 3 – NECG Submission to the Productivity Commission Inquiry into Part IIIA (18 January 2001)

Recommendation 3.12
AGL agrees that there is a need for a mechanism to provide assurance that uncovered pipelines will operate so as to facilitate effective competition. As set out in its response to the CoAG Energy Market Review Draft Report, AGL endorses the development by industry of a code of conduct for non covered pipelines to ensure a competitive market, except where revocation occurs because of the small size of the business.[38]

In its Issues Paper, the Commission raises a question as to whether there should be another category of coverage.[39] While this concept may be superficially appealing, further consideration leads to the conclusion that this approach has significant issues:

- It results in all pipelines being covered to some extent, regardless of the effect on competition and of compliance costs;
- It deviates substantially from the concept of coverage (ie declaration) contained in the National Access Regime and would therefore result in inconsistency between the National Access Regime and the industry specific gas regime;
- It raises the question of who should make the decision about the appropriate level of regulation. AGL values the principle that no one body should both make the decision about the appropriate level of regulation and then apply the regulation;
- It introduces a level of complexity in administration which will only add further cost and uncertainty to regulation;
- The definition of a test (or tests) which defines one (or more) classes of regulation will be problematic, and may result in further litigation as service providers seek to clarify which class is appropriate.

It is important that coverage (and for that matter declaration) only be initiated on the basis of a demonstrated need for access, that is, where access has not been made available - or where there is a dispute about the terms of access. Regulators are not placed to second guess the likelihood of either of these occurrences. It should be a matter for access seekers.

AGL supports the retention of a single category of coverage with a single test, and endorses the principle that new pipelines should remain uncovered unless they are shown to meet the criteria for coverage.

The Issues Paper also asks to identify the advantages and disadvantages of allowing regulators to apply for coverage of pipelines they will regulate.[40] As AGL set out in its response to the EMR Draft Report, AGL values the principle that no one body should have powers to determine what rules should apply to particular services and then to administer the rules in respect of those services.[41] Allowing one body to have this dual role is of concern to AGL. AGL also notes that the MCE, in its recent communique, announced that it was recommending to CoAG that two new statutory commissions be established; one with responsibility for rule making and market development and one with responsibility for market regulation. While these new

[38] Page 8 - AGL Response to the CoAG Energy Market Review Draft Report
[39] Pages 28 and 29 - Productivity Commission Review of the Gas Access Regime Issues Paper July 2003
[40] Page 17 - Productivity Commission Review of the Gas Access Regime Issues Paper July 2003
[41] Page 1- AGL Response to the CoAG Energy Market Review Draft Report

commissions will initially be responsible for electricity wholesale and transmission, the recommendation is that they be extended in 2005 to include gas transmission.

Recommendation 3.13
It is clear from this communique that the MCE has effectively endorsed the principle that the body that sets the rules should not also administer them.[42]

3.4 Governance of the regime - Gas Code change process

AGL considers that there is a need to increase the role of service providers in the Gas Code change processes. We also note that the MCE has recently recommended to CoAG that two new statutory commissions be established; the Australian Energy Market Commission (AEMC), responsible for rule making and market development and the Australian Energy Regulator, responsible for market regulation.[43] The Communique indicates that the new bodies will initially be responsible for electricity wholesale and transmission, extended in 2005 to include gas transmission. It also refers to an in-principle agreement to the development of a national approach to energy access covering electricity and gas transmission and distribution.

Recommendation 3.14
AGL believes that it is important to achieve a smooth transition to the new AER/AEMC regime which captures the following features: • separation of the code change decisions from the administration of the regime; • an industry based body to develop proposals for Gas Code changes.

3.5 Other

3.5.1 Ring fencing

The Issues paper raises a number of queries regarding ring fencing arrangements.

AGL considers that the ring fencing arrangements have been very effective.

As identified in AGL's submission to the EMR Issues Paper,[44] there is a trend towards the introduction of ringfencing guidelines which go beyond the simple ringfencing of infrastructure from retail activities. In pursuing the objective of removing the potential for monopoly profits, regulators are proposing requirements that discourage the use of shared resources and are likely to deter the evolution of competitive markets for the provision of infrastructure services. If there is to be any chance that the "potential second wave of disaggregation" referred to in section 3.1.2 will occur, AGL suggests that pursuing the objective of removing the potential for investors to share in benefits they create is inappropriate.

[42] Ministerial Council on Energy – Communique – Sydney, 1 August 2003
[43] Ministerial Council on Energy Communique – 1 August 2003
[44] Page 8 – AGL Response to the Energy Markets Review Issues Paper

3.5.2 Associate Contracts

The Issues Paper asks what, if any, has been the impact of requiring service providers to have associate contracts approved by the relevant regulator.[45] AGL submits that the current provisions relating to Associate Contracts need to be amended as experience has shown that these provisions are unnecessary, and worse, have the potential to impact adversely on customers, the associate retailer and the regulated service provider.

The associate contract provisions aim to ensure that where vertically integrated businesses exist, there is a level playing field.

The associate contract provisions require that the regulator must not refuse to approve a proposed associate contract unless it considers that the associate contract will have the effect, or would be likely to have the effect of substantially lessening, preventing or hindering competition in a market (section 7.1 of the Gas Code)

A contract between a regulated service provider and an associate retailer will be for either a reference service or a negotiated service. Any reference services will have been established and approved through a regulatory process involving public consultation. The process for the review and approval of reference services generally provides regulators with the opportunity to examine and make determinations in relation to potential competition issues that may arise in relation to associate contracts for reference services.

AGL submits that there is no additional benefit in requiring further regulatory approval where a service provider contracts to provide a reference service to an associate.

AGLGN's experience in contracting with retailers for network services has been that, in almost all cases, negotiated services are required to meet the needs of a large commercial and industrial end consumers rather than the retailer. AGLGN has adopted a practice of keeping end consumers fully informed of any non-reference offer made to any retailer in relation to network transportation to the consumer's site: that is, for an offer from AGLGN to the retailer to be provided to the end consumer, along with advice that the offer may be accepted by the customer directly or by any retailer (not only the requesting retailer) on behalf of the end consumer.

AGL submits that this approach means there is no potential for anti-competitive outcomes as the ultimate beneficiary of competition is in control of the process.

This approach of keeping the end consumer informed is relevant to network arrangements which are point to point services to individual customer sites. However, it is less relevant to pipeline services which generally aggregate the needs of many end consumers. The Gas Code should distinguish between these circumstances and should recognise that in the network circumstances described above, additional regulatory approval processes are redundant and, worse, impose an unnecessary costs and delays on market participants and customers.

[45] Page 31 – Productivity Commission Review of Gas Access Regime Issues Paper July 2003

Given the above approach adopted by AGLGN, AGL considers that the current associate contract approval requirements in the Gas Code have resulted in a significant waste of resources, has placed its related retailer at a competitive disadvantage and, most importantly, has inconvenienced end users.

An example is an associate contract relating to one customer for which the approval process began in November 2002. The contract related to one customer who will consume less than 10TJ pa and pay annual transportation costs of less than $50,000. AGLGN was prevented from meeting the needs of this customer until the approval process finished in March 2003, two months after the date for which the customer originally requested gas supply and involved a cost to AGLGN of approximately $25,000. This additional cost and delay was imposed on the market despite the fact that the end consumer was fully informed and was able to seek out competitive offers, but chose to deal with the associate retailer.

AGLGN has had 26 associate contracts approved since the introduction of the Gas Code, of which the contract quoted above was one of the more straight forward.

Further, even where the related retailer is the only retailer able to supply a customer, the regulated entity would still be required to seek approval for the associate contract.

Recommendation 3.15
AGL submits that the Associate Contract provisions should be amended so that regulatory approval is not required:

- For associate contracts for Reference Services;
- Where an associate retailer requests a Negotiated Service to a customer site and the service provider informs the customer of the offer made to the retailer and advises the customer that the customer can accept the offer directly or through any retailer.

In such cases, the provision should only require notification to the regulator.

In AGL's view, the proposed new provisions would have the advantage of eliminating the waste of both time and resources associated with the existing provisions, result in pro-competitive outcomes and avoid possible delays in the connection of customers to a supply of gas.

AGL's view is that it is common ground that this is the relevant market as the provisions seek to ensure a level playing field between retailers.

Recommendation 3.16
AGL considers that it would be worthwhile to amend the associate contract provisions to make it clear that the intention of the provisions is to ensure a level playing field between retailers.

Recommendation 3.17
AGL considers that it would be appropriate to make it explicit that the Associate Contract provisions only apply to transportation agreements.

3.5.3 Provisions which are not appropriate in the distribution context

Some of the Gas Code provisions are not appropriate in the distribution context. In particular, the provisions relating to trading (sections 3.9 - 3.11) and maintaining a public register of capacity (section 5.9) are not relevant in the distribution context. This is because distribution businesses are networks and these provisions are only meaningful in the context of transmission services with a limited number of receipt and delivery points.

The nature of gas networks is different from transmission pipelines in a number of respects. In the case of a pipeline, there is a clear route for receipt into the pipeline, movement through it and delivery from it. The capacity associated with a small number of routes gas may travel is fairly straightforward. In the case of a network, gas may be delivered into it via a number of receipt points and travel via a number of routes to reach its multitude of destinations.

It is not possible to trade capacity being provided for one particular delivery point for delivery to another delivery point in another network section because capacity cannot be released in one section by a reduction of use in another. Delivery points generally have a number of possible transportation routes from which supply can be obtained. The route in use at a point in time varies depending on the interaction of load profiles of all customers associated with those routes. Capacity is only shared by delivery points to the extent that they are on the same network transportation route at a point in time. Given these characteristics, there tends to be little or no capacity in common between most combinations of delivery points. This means trading capacity is of no value to most Users, but creates an inappropriate burden on the Service Provider and unreasonable expectations for Users and Potential Users.

Because a network is a complex mesh defining capacity for a segment of the network, and more especially spare capacity for it, is not a particularly meaningful exercise. Determining whether there is spare capacity in a network for a new customer can only properly be performed on a case by case basis by reference to a specific delivery point location and by reference to a detailed customer load profile. Consequently maintaining a register of capacity as also creates a significant administrative burden on the Service Provider for little or no benefits to Users.

Recommendation 3.18
The Gas Code should be amended to make it clear that such sections only apply in the transmission context.

5. SUMMARY OF RECOMMENDATIONS

Objectives

Recommendation 3.1
AGL recommends that, to ensure consistency between the generic Part IIIA regime and the Gas Access Regime, it is essential to adopt an appropriate objects clause along the lines recommended by the Commission in the National Access Regime Review, referring to the need to promote the economically efficient use of, and investment in, essential infrastructure services.

AGL also considers that there should be reference to the standard of workable competition.

It should be made clear that these objectives are paramount and these objectives should be reflected in the Gas Code and the legislation.

Pricing

Recommendation 3.2
It is important that the Gas Access Regime provides clear guidance on the treatment of efficiency gains. AGL considers that an earnings sharing model is appropriate.

The components of an earnings sharing model are:

(a) that a price glide path is set from today's average price to a target average price at the end of the next regulatory period (5 years hence);

(b) the target average price is determined as the price that would, if it applied today to the most recent year's volume sales and given the most recent years actual costs, result in a rate of return equal to the cost of capital. The difference between today's price and the target price represents efficiencies realised in the last regulatory period.

(c) By gliding from today's price to the target price, efficiencies realised in the last regulatory period are transferred to consumers progressively over the next regulatory period, and investors and consumers share in the benefits of improved efficiency.

Recommendation 3.3
AGL considers that current access pricing methodologies are too intrusive and that regulated entities should be able to choose the access pricing approach they prefer. For example, one model which should be available to regulated entities is the "price monitoring model". AGL notes that this model has been applied in the case of airports and has also been used in New Zealand.

Recommendation 3.4
AGL endorses pricing principles similar to those suggested by the Productivity Commission in its review of the National Access Regime.

For ease of reference, AGL has set out at page 17 the principles proposed by the Commission in its review of the National Access Regime, incorporating AGL's proposals in italics.

Recommendation 3.5
AGL suggests that pricing principles should make clear that

- Where the cost of capital is relevant, the variables of the weighted average cost of capital shall be determined by a panel of experts. Industry and the regulator must apply the variables which have been determined by a panel of experts;
- Where the cost of capital is relevant, the risk component shall be fixed for the life of an asset;
- Capital expenditure that is deemed prudent at the time of investment shall not be stranded at some future time;
- Where forward prices are fixed by regulation, they shall be set on the basis of actual costs and volume sales at the time of price fixing, not on the basis of forecasts; and
- Investors shall share in all realised improvements in efficiency, not only in improvements that exceed regulator benchmarks.

Recommendation 3.6
AGL submits that it is important that, in addition to the high level pricing principles above, the Gas Code is amended to explicitly provide for the earnings sharing model.

Appeal mechanisms

Recommendation 3.7
There should be provision for merits review:

(i) of a Final Decision; and
(ii) of an access arrangement drafted and approved by the regulator.

The grounds of appeal for each should be the same. Amendments that are needed to the grounds of appeal are:

(a) section 39(2) of the Gas Pipelines Access Act should be deleted;
(b) section 39(5) of the Gas Pipelines Access Act should be amended to provide:

"The matters to which the relevant appeals body, in reviewing a decision made under this section, must consider are:
(a) the application for review and submissions in support of the application;
[(ab) – (f) remain unchanged];
(g) any other matter the appeals body considers relevant".

Recommendation 3.8
AGL submits that the regime should be amended so, in relation to section 6 of the Gas Code, the regulator cannot be the arbitrator.

Incentives for investment in Greenfields developments

Recommendation 3.9
AGL considers that providing long term exclusive franchises for a pre-determined time period would greatly assist the viability of greenfields distribution and facilitate new investment.

Recommendation 3.10
AGL's preferred approach is to allow the performance of the project itself to determine the duration of the holiday -- the holiday would extend to the point when (if ever) the cumulative NPV of the project becomes positive. From that point onwards the "blue sky" would be shared between the investor and consumers in a pre-agreed manner. The fact that the upside of successful outcomes will be shared does reduce their economic value, but in a manner which is known to the investor: most importantly the investor is assured at the outset of a share of any "blue sky". This can be contrasted with the outcome under a fixed term holiday.

Coverage

Recommendation 3.11
The Commission's recommendations in relation to the declaration criteria in Part IIIA should be applied to the coverage criteria in the Gas Code. The coverage test should be amended so that coverage would have to lead to a "substantial increase" in competition.

Recommendation 3.12
AGL agrees that there is a need for a mechanism to provide assurance that uncovered pipelines will operate so as to facilitate effective competition. As set out in its response to the CoAG Energy Market Review Draft Report, AGL endorses the development by industry of a code of conduct for non covered pipelines to ensure a competitive market, except where revocation occurs because of the small size of the business.

Recommendation 3.13
It is clear from this communique that the MCE has effectively endorsed the principle that the body that sets the rules should not also administer them.

Gas Code change process

Recommendation 3.14
AGL believes that it is important to achieve a smooth transition to the new AER/AEMC regime which captures the following features:

- separation of the code change decisions from the administration of the regime;
- an industry based body to develop proposals for Gas Code changes.

Associate contracts

Recommendation 3.15 AGL submits that the Associate Contract provisions should be amended so that regulatory approval is not required: • For associate contracts for Reference Services; • Where an associate retailer requests a Negotiated Service to a customer site and the service provider informs the customer of the offer made to the retailer and advises the customer that the customer can accept the offer directly or through any retailer. In such cases, the provision should only require notification to the regulator.

Recommendation 3.16 AGL considers that it would be worthwhile to amend the associate contract provisions to make it clear that the intention of the provisions is to ensure a level playing field between retailers.

Recommendation 3.17 AGL considers that it would be appropriate to make it explicit that the Associate Contract provisions only apply to transportation agreements.

Provisions which are not appropriate in the distribution context

Recommendation 3.18 The Gas Code should be amended to make it clear that such sections only apply in the transmission context.

Appendix A – the seven uncertainties

As set out in section 3.1.2, AGL has identified at least seven sources of uncertainty. AGL submits that all of the identified uncertainties could be resolved by clearly stated pricing principles. Details of each of the sources of uncertainty are set out below.

(i) Uncertainty regarding the initial regulatory rate of return for new infrastructure and uncertainty as to whether the rate for successful investments will be subsequently reduced.

In assessing an investment opportunity, AGL accepts the need to factor in the vagaries of the market, and the possible fluctuations in costs and demand. However, it is unacceptable to have to second-guess the regulator on a matter such as the regulatory rate of return. The current regime results in significant uncertainty regarding the initial regulatory rate of return for new infrastructure and uncertainty as to whether the rate for successful investments will be subsequently reduced.

AGL does not seek a guaranteed rate of return. AGL accepts that this will be a function of its effort and market movements. However, AGL does want to know the assumption the regulator is going to make in setting prices AGL can charge. Given that a regulator must make this decision at some time, it is not unreasonable to ask that it be made before the investment occurs rather than after the event as is the case at present. Not providing this information simply increases the uncertainty of making investments, thereby increasing costs and prices.

AGL does not consider that it is sufficient to rely on precedent to understand what decision the regulator might make about cost of capital.

AGL considers that it is reasonable that the regulatory rates for a range of investments be disclosed.

(ii) Uncertainty as to whether the regulator will, in future price determinations, reduce the risk component of the rate of return for successful investments from the figure set initially.

It is unlikely that a decision will be made to invest unless expected returns on the project equal or exceed the cost of capital that is consistent with the risk foreseen at the time the investment decision is made. When the performance of an investment is reviewed, actual returns are measured against the benchmark returns on which the investment decision was made. That is, against the cost of capital consistent with the risk foreseen at the time the investment was made. If actual returns exceed this benchmark, the investment has been successful, if they fall short of the benchmark, the investment has not been successful.

Investors in regulated assets currently face the risk that regulators will reset prices at subsequent price reviews on the basis of an assessment of the risks of the project at the time of the reset. Once a project is known to be successful, future risk is likely to be less than the risk at the time the investment was made and therefore prices will most likely be reset to recover returns lower than those consistent with the view of risk at the time the investment was made. Price resets will inevitably result in successful projects earning a return lower than the benchmark which distinguishes good investments from poor investments. That is, regulators are likely to turn good investments into poor investments. On the other hand, there is nothing a regulator can do to turn a poor investment into a good one.

This risk would be removed if there were a pre-investment commitment to set prices at subsequent reviews on the basis of the pre-investment view of risk.

(iii) Uncertainty as to whether actual capital expenditure on additions will be allowable in price determinations or whether part will be deemed imprudent; and as to whether an investment deemed prudent at the time of investment will in future be deemed redundant, in whole or in part.

Infrastructure investments exhibit significant economies of scale – a few large pipes are a much more economical solution than many small ones. In fact it is this feature of infrastructure investments which gives rise to their characterisation as natural monopolies.

Access regulation presently allows regulators to ‘strand’ assets, in whole or in part, if they are not fully utilised. Thus, if the investor sizes an asset to take advantage of economies of scale, there is the attendant risk that the assets will at some time be stranded. This sends strong messages to investors so "size" assets so that at all times there is no excess capacity. The result is that valuable economies of scale are not realised. Therefore, it is critical to remove this discretion from regulators.

(iv) Uncertainty as to whether benefits from taxation investment incentives will be removed through regulatory price determinations after the investment has been made

From time to time the Federal Government determines that it is in the interests of the economy generally to stimulate infrastructure investment. Such policy decisions are usually effected through investment allowances, generally in the form of accelerated depreciation for taxation purposes.

In recent decisions under the Gas Code, the ACCC has applied what it terms its post tax revenue model to price setting. The effect of this model is to transfer any benefit offered by investment allowances from investors to consumers in lower prices. For the past investor this amounts to the retrospective confiscation of a benefit. From the perspective of a potential investor, it means that Government incentives designed to bring forward infrastructure investment cannot be relied upon. From the perspective of managing the economy, it means that an important instrument of policy has been neutered.

(v) Uncertainty as to whether actual operating costs incurred by an efficient operator will be recoverable in regulated prices

The drafting of regulatory regimes in Australia reflects a preoccupation with removing monopoly rents, where monopoly rent has been taken to exist if actual or forecast costs exceed, or could exceed, ‘efficient’ costs. In giving effect to that preoccupation regulators have attempted to ‘fine-tune’ estimates of ‘efficient’ costs which then form the basis of regulated price determinations.

Efficient costs are a useful concept, but translating that concept into practice is a very inexact process. Regardless of whether the search for efficient costs is based on engineering models or comparative benchmarking, the foundation for both approaches is comparative benchmarking. However, benchmarking used for the purpose of estimating efficient costs is approximate at best. The sources of its imprecision are well documented by Professor Vogelsang[46], NERA[47] and others. They include difficulties associated with apples with apples comparisons, and with normalising data to remove the effects of external factors.

Efficient costs are difficult, if not impossible, to determine and any estimate of efficient costs can only be properly expressed as a range which is so wide as to render them of little practical use. The Productivity Commission refers to the difficulty 'inherent'[48] in attempting to discover efficient costs and suggests that the information requirements are 'daunting'[49] particularly if access prices are based on the 'efficient' cost of supply. The search for 'efficient' costs for a forecast period of five years or so is even more daunting and the results even more uncertain. As IPART says: "No regulator can accurately assess the levels of efficiency or service an industry is capable of over time."[50]

While the reality is that 'efficient' costs can only be properly expressed in terms of a very wide range, and despite the fact that if investment is not to be discouraged, price determinations should be based on the high end of the range, the fixation with removing monopoly rents has caused regulators to land well below the top end of the range.

As a consequence, investors have no assurance that regulated prices will in fact allow recovery of genuine costs even when they operate efficiently.

(vi) Uncertainty as to how efficiencies will be treated, and to what extent, if any, that the owner will get to share in them; and as to how shared costs will be treated, whether the owner will get to share in any realised synergies, and whether the owner will be free to allocate shared costs in an economically efficient manner

Incentive regulation is intended to drive owners of infrastructure to innovate by offering them a share in the efficiencies that are produced. However, existing regulatory practices undermine this incentive.

As mentioned previously, regulated prices set on the basis of regulator estimates of 'efficient' costs leave investors uncertain as to whether prices will allow recovery of genuine costs for an efficient operator. In addition, by setting prices on the basis of regulator estimates of forward-looking 'efficient' costs, regulators are awarding 100 percent of what they consider to be achievable efficiencies to customers. Investors get no share in them at all. If regulators over-estimate the potential for efficiencies, then they will transfer to customers the benefits of efficiencies that cannot reasonably be realised. In this case, the share to the investor is negative.

Proper incentive regulation requires that only realised efficiencies be shared, and a commitment up front as to how they will be shared. There is no value in keeping this matter

46 Ingo Vogelsang; A 20-Year Perspective on Incentive Regulation for Public Utilities; ACCC Regulation and Investment Conference; Sydney March 26/27, 2001
47 NERA
48 Productivity Commission 2001at page 206
49 Productivity Commission 2001at page 68
50 IPART, p3

secret; to do so only undermines the very incentives on which the system is supposed to be based.

(vii) Uncertainty as to how greenfields and regional development investments are to be treated

There are investment issues, in addition to those already raised, that are unique to greenfield developments. This particular uncertainty is discussed in detail in section 3.2 of this submission.