Submission to the Productivity Commission

re Inquiry into the Review of the Gas Access Regime

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Executive Summary

The attached document sets out the submission of Multinet Gas Distribution Partnership (Multinet) and Alinta Gas Networks (Alinta) to the Productivity Commission's review of the gas access regime.

The review of the gas access regime provides policymakers with a very timely opportunity to address and remedy the deficiencies that were identified during the Productivity Commission's recently concluded review of the national access regime, and the recent decision of the WA Supreme Court in the case brought by Epic Energy in relation to a draft decision of the Independent Gas Pipelines Access Regulator.

A separate submission prepared by the Australian Gas Association (AGA) examines in detail the implications of these two very important independent reviews of the performance of access regulation. Multinet and Alinta strongly support and endorse the AGA submission. Our own submission reiterates some of the key themes of the AGA submission and expands on other matters.

Our submission argues that the National Gas Code is deficient in a number of regards. We therefore make a number of suggestions aimed at improving the Code. Our key suggestions are summarised below:

- We strongly concur with the recommendation of the Productivity Commission's review of the national access regime, regarding the need to clarify the regulatory objectives of the Code. In this context, we are concerned to see that the objectives are clarified in a manner consistent with the guidance provided by the WA Supreme Court's decision in the recent Epic case. In particular, we are keen to see the objective changed to require regulators' decisions to deliver outcomes that are consistent with that which would occur in practice in a "workably competitive" market – as distinct from the theoretical construct of a "perfectly competitive market".

- There is a clear need to incorporate more robust appeal arrangements into the Code, to enable the owners of essential facilities to seek merit-based reviews of regulators' decisions. The strengthening of appeal arrangements would provide greater regulatory accountability, and more effective protection of the legitimate property rights of facility owners especially with the intrusive nature of the "building blocks" regulatory pricing model. We consider that delivery of effective appeal outcomes is an essential requirement if access regulation is to facilitate the maximisation of economic welfare over the longer term. However, appeal arrangements are not required for some pricing options such as Price Monitoring, although the economic welfare objective would remain.

- We believe that there is scope for the adoption of different approaches to the regulation of prices and service standards, to address the widely acknowledged problems with the "building block" model. In particular, we note that the Victorian gas distributors have already been subjected to two detailed cost of service reviews over the past six years. These reviews have resulted in the removal of any rents from the revenue streams of the businesses, and the broad alignment of the businesses' revenue requirements with efficient costs. Given these considerations, the on-going application of a detailed cost of service regulatory approach is unwarranted, and is, in itself unduly costly.

- An alternative to the cost of service regulatory approach is required, to facilitate greater commercial negotiation, and to encourage dynamic efficiency and the maximisation of welfare over the longer term. One credible alternative that has already been established successfully (in the airports sector) is price monitoring. A price monitoring approach would provide a means of strengthening the incentives for distributors to deliver services that meet customers' needs in an efficient manner over the long term, whilst minimising the direct and indirect costs associated with more intrusive forms of regulation such as the "building block" approach.

1.0 Introduction

This submission is from Multinet Gas Distribution Partnership (Multinet) and Alinta Gas Networks (Alinta). Multinet is an urban distributor servicing some 626,000 gas connections in Melbourne's eastern suburbs and Alinta is a gas distributor and retailer which serves more than 440,000 gas customers in Western Australia.

The companies welcome the release of the Issues Paper prepared by the Productivity Commission and the Review of the National Access Regime. The access regime has critical impacts on private and publicly owned regulated gas businesses in term of prices and investments in essential infrastructure. The gas network sector across Australia delivers gas to some 3.5 million business and domestic consumers with some 75,000 kilometres of low to medium pressure pipes.

Ensuring appropriate incentives for ongoing reinvestment in gas distribution pipelines is particularly important and challenging given the difference between the long economic and technical life of the pipelines and the short-term regulatory periods.

The companies believe that the National Gas Code (the Code) is in need of substantial reform especially after the decision of the Western Australian Supreme Court in the Epic Energy case (the Epic case). Henry Ergas of NECG has commented that the Epic case demonstrated that:

> "Ultimately, the main conclusion to emerge from these proceedings is that the Code is desperately in need of reform. It sets goals that are confused at best, inconsistent at worse. It grants regulators vast discretion, while nonetheless imposing mind-numbing, highly detailed, requirements on the precise form (but not the substantive outcome) of the regulatory process. And it frees that discretion from effective review by the Courts, which are limited to matters of law, and hence cannot set out clear guidance of the kind the Australian Trade Practices Tribunal (now the Australian Competition Tribunal) has so effectively given in respect of the Trade Practices Act."1

This submission agues that the Code is deficient in a number of regards and makes a number of reform proposals including the:

- incorporation of improved regulatory objectives in the Code;
- adoption of different approaches to the regulation of pricing based on sound economic criteria;
- need for greater commercial negotiation and the encouragement of dynamic efficiency; and
- incorporation of improved appeal structures.

1 Henry Ergas, NECG "Briefing on Epic Decision", Paper for the IPA Forum on Epic Appeal, 11 June 2003, p. 13.

2.0 Clear and Appropriate Objectives for the Gas Access Regime

This section is based largely on the AGA submission to the Review of the Gas Access Regime but has some important differences.

As established by the Epic case the gas access regime does not have a clear set of policy objectives which has resulted in a lack of clarity about the objectives of regulation, and has led to a lack of appropriate emphasis on the incentives for dynamic investment.

A clear and appropriate set of policy objectives for the gas access regime would:

- replace the inconsistent and contradictory objectives in the existing regime;
- ensure regulatory authorities adequately considered the long term interests of gas users in ongoing investment when making access pricing decisions;
- facilitate efficient commercial negotiation on terms and conditions of access by giving a greater emphasis to dynamic efficiency;
- base pricing methodology on sound economic criteria;
- reduce the risk of regulatory error and increase regulator accountability; and
- recognise 'workable competition' as the key competition test for the access regime.

2.1 Existing regulatory guidance in the gas regime – objectives of regulation

The Productivity Commission found in its inquiry into the National Access Regime an almost complete absence of clear direction for regulatory authorities and regime participants on the objectives of regulation. However, this issue is reversed in considering the Gas Access Regime. In this regime there is a profusion of possible objectives. This creates uncertainty and increased costs for regulated businesses, access seekers, regulatory authorities and gas consumers.[2]

Importantly, the Code itself contains no formal or binding objects clause, despite the conflicting range of objectives reviewed by the Western Australian Supreme Court in the Epic case.[3]

2.2 Ensuring Promotion of Long-Term Economic Welfare

Effective regulation must be focused on specific objectives that clearly link targets and desired outcomes.[4] A clear objects clause would enable the Code to provide a more appropriate emphasis on the long-term interests of the community and potential users in having access to a reliable gas network.

2 These conflicting provisions have been clearly outlined in the submission by the AGA to the Review of the Gas Access Regime, August 2003, pp. 26-28 and include sections 2.24, 8.1 and 8.2.
3 *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231.
4 Productivity Commission, Review of the National Access Regime, Inquiry Report No. 17, 28 September 2001, p. 124.

The Productivity Commission has emphasised that an objects clause should not merely seek to outline an indefinite range of considerations underpinning an access regime, but seek to give guidance to regulatory authorities and to other participants and embody what the Hilmer Committee termed 'policy judgements'. The Commission stated:

> "…the Commission considers it appropriate to give particular weight to ensuring that investment in essential facilities is not jeopardised. While it is unarguable that access can promote investment in markets using the services of essential facilities, such investment is contingent on preserving incentives to build or expand those facilities in the first place."[5]

Enshrining such judgements as objectives in the gas access regime would significantly increase effectiveness of the regime.

2.3 Encouraging Commercial Negotiations

The propose-respond model is set out in Sections 2.1-2.52 of the NGC (and similar general provisions are contained in the sections of the *Trade Practices Act 1975* in relation to access undertakings). It provides that a service provider can propose terms and conditions, including default transportation tariffs, to be applied for third party access.

The proposed-respond model functions most effectively where prices and terms proposed by service providers are assessed by regulatory authorities with a clear recognition of the individual commercial and operational context of the network or pipeline, rather than with any pre-determined views of outcomes and approaches which should be pursued.

The increased certainty and clearer guidance an objects clause would provide has the potential to facilitate increased commercial negotiations and settlements on the terms and conditions of access. This was a critical goal of the gas access regime, which has not been realised during the operation of the Code. The original regime envisaged effective commercial negotiations based on:

- a right of access to a basic 'default' service on a fair and reasonable set of terms and conditions – as a backstop to commercial negotiations likely to involve more sophisticated and individually tailored agreements on price and service
- both the asset owner and the prospective user offering adequate information to facilitate fair commercial dealing – with an obligation on the service provider to prepare and make public an Access Arrangement Information to assist in this goal.

The application of the gas access regime has undermined these original elements of the regime, and gradually transformed the regime into one based on where:

- access seekers not seeking commercial negotiations with regulated businesses, rather opting to rely exclusively upon a narrow range of regulator imposed Reference Services (service offerings) which are defined and developed by regulatory action as a proxy for outcomes of genuine commercial negotiations;

[5] Productivity Commission (September 2001), p. 128.

- high levels of prescriptive information gathering from regulatory authorities, extending to information irrelevant to the establishment of default tariffs.[6]

The Commission also supported a key feature of an effective propose-respond model, the ability of a service provider to develop their own price structures that reflect commercial judgements:

> Because the structure of prices is important, instruments that allow service providers to develop their own price structures are likely to be preferable to those where the regulator is required to impose a structure.[7]

More appropriate initial guidance about the objectives of the gas access regime may have prevented this significant and unintended transformation of the regime.

2.4 Reducing the Risks of Regulatory Error

Without clear guidance about the purpose of the access regime regulatory errors and regulatory failure, of the kind identified in the Productivity Commission's review of the generic third party access regime, is virtually inevitable.

Regulatory error is evident in many aspects of the operation of the current gas access regime, including the:

- adoption by regulatory authorities of unrealistic levels of precision in the application of the Capital Asset Pricing Model;
- use of economic principles in some areas of the Code but not in others and variations to these principles often to ensure lower rates of return;
- imposition of access pricing regulation to market circumstances where dynamic market changes makes restrictive price regulation unnecessary.

The use of the CAPM model by regulators under the Gas Code has assumed a greater degree of certainty and precision than is available from the theoretical model. Henry Ergas (NECG) has argued that:

> "The Code requires regulators to determine a regulated business's efficient costs, and then decide on the pricing mechanism the business can adopt to recover the costs from consumers. To make such decisions, regulators have adopted an intrusive "cost of service" approach, which is required by the Code. This involves making assumptions about the cost model for the business. Regulators must estimate (among other things) the efficiency of the business, the economic profile for the asset consumption and the business's weighted average cost of capital (WACC).

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6 The Regulator, at least in Victoria, has unconstrained information gathering powers as part of the state licensing conditions. The relevant clause in the Multinet licence states (Clause 12): "The Licensee must provide to the Office, in the manner and form and at the time decided by the Office and notified to the Licensee, such information as the Office may from time to time require."

7 Productivity Commission (September 2001), p. 340.

> The problem is that accurate information for several of these parameters does not exist. But this has not deterred the regulators. For example, even though market information does not exist to quantify some of the key parameters of the WACC, regulators have consistently prepared to move to the bottom of a range of acceptable values, to assume that the enterprises' capital will be comparatively cheap. Pity the company whose capital is relatively expensive. To make matters worse, regulation has been applied as a one-way bet, bad luck if the regulated business cannot recover its costs, but rest assured it will never earn more than the "normal" return on investment.
>
> This has led independent bodies, such as the Productivity Commission to openly question whether regulatory decisions are seeking a level of precision that cannot be achieved. This is not merely an academic interest – the stakes for the whole Australian economy are very high."8

Regulators have used economic principles in some areas of the Code but not in others especially when they may be used to increase returns to regulated businesses:

- The use of asset valuation techniques such as the Depreciated Optimised Replacement Cost (DORC) has been justified in terms of a "contestable" market but Professor King argues that regulators have misapplied "contestable" theory to ensure a lower asset valuation.[9]
- Regulators in implementing earning sharing mechanisms have used "own" costs rather than the industry average Total Factor Productivity (TFP) on which to base efficiency sharing biasing against efficient firms.
- Regulators have argued that regulated returns in Australia are comparable with international experience but NECG has concluded that there is no evidence to support the ACCC proposition that WACC allowances in Australia are favourable against the UK and the US experience. In comparison US regulators provide significantly higher WACC allowances that Australian regulators.[10]

These inconsistencies in the regulatory regime clearly show the need for an improved objectives clause and a different non-cost based method of regulation.

2.5 Using 'workable competition' as the regulatory market test

The lack of clarity regarding the overarching objective of the regime has been highlighted in critical judicial developments regarding the type of competition, which the regulatory regime should seek to simulate.

Since the introduction of the access regime, regulatory authorities have generally applied the Code to replicate the outcome of a theoretically perfect competitive market. This approach is inconsistent with the decision of the Western Australian Supreme Court in the Epic Energy case, which clearly illustrated the poor level of guidance on core issues regarding the objectives of regulation.

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8 Henry Ergas "Off with their heads", *Business Review Weekly*, 14 August 2003, p. 55.

9 Stephen King "Report on Agility's approach to DORC valuation", November 21, 2002 and "Report on the construction of DORC from ORC", February 14, 2001.

10 NECG "International Comparison of WACC Decisions", paper prepared for the Regulated Infrastructure Forum as a submission to the Gas Code Inquiry, August 2003.

Applying the regime to replicate 'perfectly' competitive markets?

Regulatory authorities have generally interpreted Section 8 of the Code as supporting an approach to access pricing regulation that seeks to replicate the outcomes of a perfectly competitive market. While Section 8.1 refers to an objective of replicating a competitive market, the issue of the type of competitive market was left unresolved in the access regime.

Evidence of the assumption by regulatory authorities that they should seek to achieve outcomes consistent with a standard of 'perfect' competition is contained in regulatory decisions made prior to the Epic Energy case. For example, the Victorian Essential Services Commission stated in relation to its gas distribution pricing review in 2002 that in relation to applying the principles in Section 8.1:

> In reconciling these objectives, the Commission considers it appropriate for reference tariffs to be set *at a level that is just sufficient to ensure continued service provision*.[11] [emphasis added]

The Australian Competition and Consumer Commission (ACCC) have adopted an even more ambitiously precise approach. In its *Draft Greenfields Guideline for Natural Gas Transmission Pipelines* the ACCC has signalled that it considers regulated reference tariffs represent the outcomes of a perfectly competitive market by stating:

> …in principle a negotiated tariff would only be expected to be greater than a reference tariff to the extent that the service provider can exert market power.[12]

Both of these approaches have been invalidated by judicial statements and precedents in the *Duke Eastern Gas Pipeline* appeal and the Epic Energy case. In the Epic Energy case the Court determined in relation to Section 8.1 that:

> …it would distort the words used to engraft a sense of "*no more* than the efficient costs" into s 8.1(a).[13]

Reconciling this judicial statement with the Victorian Essential Services Commission approach to access pricing which is focused on revenue being 'just sufficient' to ensure continued service provision is extremely problematic. The Australian Competition Tribunal (the Tribunal) in the *Duke Eastern Gas Pipeline* appeal delivered an equally powerful rebuttal to the ACCC's contention that any difference in regulatory pricing outcomes and commercially negotiated tariffs represent the presence of market power when it stated:

> This argument does not take sufficient account of the fact that regulation is a second best option to competition. The complex nature of the tariff-setting process, the number of assumptions it relies on, and the fact that the reference tariff is a publicly available price which may be varied by negotiation between the pipeline owner and user depending on the user's requirements and conditions in the marketplace, all point to the fact that the reference price is not necessarily the price which would result from competition.14

11 Essential Services Commission Review of Victorian Gas Access Arrangement – Draft Decision, July 2002, p. 45.
12 ACCC Draft Greenfields Guideline for Natural Gas Transmission Pipelines, June 2002, p. 24.
13 *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [142].
14 Australian Competition Tribunal: Duke Eastern Gas Pipeline Pty Ltd [2001] AcompT 2 [110].

The assumption by regulatory authorities that the Code required them to seek to replicate outcomes from theoretically 'perfect' competitive markets was questioned by the Productivity Commission's *Review of the National Access Regime*, and subsequently, the Supreme Court decision in the Epic Energy case. As the Productivity Commission stated in its review of the generic access regime:

> …regulators should not be too ambitious in their approach, and that governments should not place too great a level of expectations upon them. A sensible goal is to improve significantly on unregulated outcomes, while recognising that precision is not possible.[15]

In addition, the Commission noted that there is a need for regulatory authorities in assessing access-pricing issues not to engage in regulatory overreach:

> These considerations suggest that regulators should not be too ambitious in their approach, and that governments should not place too great a level of expectations upon them. A sensible goal is to improve significantly on unregulated outcomes, while recognising that precision is not possible.[16]

In the Epic Energy case the issue of the standard of competition appropriate for regulatory authorities to have regard to in applying the gas access regime was a key issue. In this judicial precedent, a standard of 'workable competition' was adopted by the Court in analysing the legal errors made by the Western Australian Office of Gas Access Regulation in applying the National Gas Code to the Epic case. As an example, the Court noted that access pricing based on narrow assessments of 'efficient costs' was insufficient to discharge a regulatory authority's broader obligations to the legitimate business interests of the service provider by saying:

> …in a workably competitive market past investments and risks taken may provide some justification for prices above the efficient level.[17]

A lack of clarity over the standard of competition which is sought to be encouraged by the gas access regime, and the inconsistency of the approach of regulatory authorities with judicial outcomes under the regime emphasises the need to ensure governments, regulatory authorities and market participants have a clear understanding of the objectives of the gas access regime.

15 Productivity Commission (September 2001), p. 340.
16 Productivity Commission (September 2001), p. 340.
17 *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [144].

Recommendation 1

It is recommended that the objectives set out below form the new objects clause in the National Gas Code:

The objective of the National Gas Code is to:

(a) promote the economically efficient operation and use of, and investment in, essential infrastructure services, consistent with that which would occur in a workably competitive market, thereby promoting effective competition in upstream and downstream markets;

(b) provide a framework and guiding principles for commercial arrangements and regulatory determinations; and

(c) maximize the long-term economic welfare of the community.

3.0 Appeal Rights under the National Gas Code

3.1 Introduction

This section is also largely based on the AGA submission to the Review of the Gas Access Regime but differs in some important respects.

Full and fair appeal rights are an essential component of an effective and efficient regulatory model. The companies do not consider that the Code has provided an adequate model for appeal rights on the basis that appeal rights differ between coverage and pricing issues. Indeed there are wide differences between all the energy codes.

In a key address by the Chairman of the Productivity Commission he outlined the value of an efficient and effective appeal system:

> "A related issue to determining the right thresholds for regulatory action is that where the potential costs of regulatory action are high there should be the capacity for verification that the right diagnosis has been reached. Different competition regimes in Australia have different standards of accountability.
>
> For example, in the national access regime under Part IIIA, declarations are appealable to the Australian Competition Tribunal, whereas under the telecommunications access regime in Part XIC, no appeal rights exist for declaration at this stage. As evidenced by the Duke decision, regulatory error can occur, with the Tribunal as a useful second umpire"[18]

An important aspect of appeals models is that the greater the level of regulatory controls in an industry the greater the need for full merit appeal systems. This is because the dangers to the expropriation of private property rights are most at danger in such regulatory "building block" models. As such the discussion below is predicated on the continuation of the "building block' regulator model or the introduction of some other costs based or intrusive regulatory model. A full merit appeal system is not required in price monitoring providing the review of price monitoring at the completion of the period is undertaken by a qualified independent body and not the regulator.

3.2 Access to Effective Appeal Mechanisms

Role of Effective Appeal Arrangements

Appeal mechanisms play a critical role in administrative and legislative frameworks across society. The Productivity Commission in their review of the National Access Regime commented that:

> "As the Commission emphasised in the Position Paper, appropriate protection for property rights must be the pre-eminent consideration in formulating a system of appeal rights for access regimes"[19]

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18 Gary Banks, Chairman Productivity Commission, "Regulating Australia's Infrastructure: Looking Forward", Presentation to the Financial Review and AusCID National Infrastructure Summit, Melbourne, 14-15 August 2002, p.10.

19 Productivity Commission (September 2001), p. 396.

Robust and effective appeal mechanisms (including both judicial and merits-based review) are critical components of effective third party access frameworks for a number of reasons. Appeal mechanisms:

- improve accountability in regulatory decision-making;
- assist in the transparency of regulatory decisions and decision-making processes;
- use legal interpretations on the regulatory framework to provide more certainty about its application over time;
- reduce the risks to the community and service providers of regulatory error and failure;
- recognise the continuing property rights of owners of sunk capital investment especially when regulatory periods are shorter than the technical and economic life of the assets;
- better support private sector investment in new and existing long-lived capital assets.

The Productivity Commission also outlined their support on cost-benefit grounds for an effective and efficient appeal system:

> "While a number of other participants also acknowledged that provisions for merit review of undertakings would involve some additional costs and delays, they contend that these costs would be more than outweighed by the benefits of promoting thorough analysis of the issues at hand. Moreover, some went on to suggest that other mechanisms could and should be used to limit these additional costs. Thus the Australian Gas Association commented that:
>
> *Any concerns regarding the timeliness of decision making which arise from the proposal to allow reviews of undertaking decisions should be addressed through tighter rules on decision making not through retaining restrictions on access to merit reviews (sub DR84, p.11)*
>
> The Commission agrees with this argument."[20]

Merit appeals to the Australian Competition Tribunal is a better appeal framework because it can be used to update codes with relevant changes over time compared to a lack of updating of the Code from current state based appeal structures:

> And it frees that discretion from effective review by the Courts, which are limited to matters of law, and hence cannot set out clear guidance of the kind the Australian Trade Practices Tribunal (now the Australian Competition Tribunal) has so effectively given in respect of the Trade Practices Act."[21]

Full merit reviews are also essential to updating codes as these can lead to a broader range of issues covered in any such appeal and the consideration of subjective matters in the relevant code.

[20] Productivity Commission, (September 2001), p. 390-391.
[21] Henry Ergas, NECG "Briefing on Epic Decision", (11 June 2003), p. 13.

3.3 Appeals under the National Gas Code

Appeals under the Code are set out in the tables below:

Table 1: Appeals under the National Gas Code

	Transmission	Distribution
1. Coverage Decisions		
• Recommendations	National Competition Council (NCC).	National Competition Council (NCC).
• Decisions	If the pipeline is located in one jurisdiction: the Commonwealth Minister, except in SA, WA and NT where it is the local minister.	If the pipeline is located in one jurisdiction, the local minister.
	If the pipeline is located in 2 or more jurisdictions: the Commonwealth Minister.	If the pipeline is located in 2 or more jurisdictions: the local minister of the jurisdiction "most closely connected".
Administrative appeals	For appeals from the Commonwealth Minister: Australian Competition Tribunal (***ACT***) but under the Gas Access Pipelines Law appeal requirements. For appeals from the local minister: the ACT, except in SA and WA where it is the local appeals body but under the Gas law appeal requirements.	For appeals from the local minister: ACT, except in SA and WA where it is the local appeals body. Appeals under the Gas Access Pipelines Law.
2. Regulatory decisions including in relation to access arrangements		
• Decision	Australian Competition and Consumer Commission, except in WA where local regulator.	Local regulator.[22]
• Administrative appeals	From decisions of the ACCC: the ACT. Appeals are under the Gas law.	From decisions of the local regulator: local appeals body.[23] Appeals are generally under the Gas Access Pipelines Law.

[22] The local regulators are:
- New South Wales: Independent Pricing and Regulatory Tribunal;
- Victoria: Essential Services Commission;
- Queensland: Queensland Competition Authority;
- South Australia: South Australian Independent Pricing and Access Regulator;
- Western Australia: Western Australian Gas Review Board;
- Tasmania: Tasmanian Energy Regulator;
- Australian Capital Territory: Independent Competition and Regulatory Commission;
- Northern Territory: Australian Competition and Consumer Commission.

[23] The local appeals bodies are:
- New South Wales: NSW Gas Review Board
- Victoria: Essential Services Commission Appeals Panel;
- Queensland: Queensland Gas Appeals Tribunal;
- South Australia: The District Court;
- Western Australia: Western Australian Gas Review Board;
- Australian Capital Territory: Australian Competition Tribunal;
- Northern Territory: Australian Competition Tribunal.

Judicial appeals were originally established under the Code to the Federal Court. However with the constitutional challenge to the states access to the Federal Court judicial review is now undertaken by the relevant state Supreme Court. However, the Commonwealth and Northern Territory Application Acts still use the Federal Court for judicial review. The recent appeal by EPIC to the WA Supreme Court on the basis of a draft decision is an example of a judicial review on a matter of law.

3.4 Appeal Issues under the Code and the National Electricity Code (NEC)

Current appeal mechanisms are inconsistent between jurisdictions and between energy industries, and the right to full merits-based review is effectively not available for pricing decisions in the energy industry as shown in the table below:

Company Type	Appeal Grounds for Pricing Decisions
Gas Transmission	Merit appeals to the Australian Competition Tribunal (except in WA) but under the Gas Pipelines Access Law appeal provisions (S.39) but the question of the appeal powers is still in some dispute in the current Gasnet appeal.
Electricity Transmission	Appeals on pricing determinations to the relevant Supreme Court (or Federal Court). Only judicial review available except for some limited technical and administrative merit appeals under the NEC.
Gas Distribution	Merit appeals to state regulators, except in NSW, under the Gas Pipeline Access Law appeal provisions (s.39). No access to full merit appeals.
Electricity Distribution	Appeals to state Supreme Courts or Federal equivalents unless covered by state legislation such as in Victoria. Some limited technical and administrative appeals under the NEC.
Coverage under the National Gas Code	Appeals under the Gas Pipelines Access Law under S.38 with full merit appeal rights.

Grounds of appeal need to be clear

A key part of an effective appeal procedure is clearly defined grounds of appeal. Under the gas access regime there is a lack of national clarity and consistency regarding the grounds of merits review of a decision.

Coverage decisions can be appealed under S. 38 (9) of the *Gas Pipelines Access Law* (the Gas Law) and this permits a full merit review of the Minister's coverage decision;

> In proceedings under this section, the relevant appeals body may make an order affirming, or setting aside or varying immediately or as from a specified future date, the decision under review and, for the purposes of the review, may exercise the same powers with respect to the subject matter of the decision as may be exercised with respect to that subject matter by the person who made the decision.

Section 39 of the Gas Law principally governs the pricing and access appeal arrangements of the gas access regime. It provides that appeals may be made on the basis of:

- error of fact
- incorrect or unreasonable exercise of discretion
- exercise of discretion where none exists

The terms under s.39 are substantially narrower than the full merit review model which is available for coverage decisions under s.38 of the Gas law.

Electricity distributors have significantly less merit appeal rights. Except in Victoria, electricity distributors must appeal to the relevant Supreme or Federal Court for pricing and access matters. This is also the case for electricity transmission companies.

In Victoria, electricity distributors have rights of merit appeal under s.55 and s.56 of the 2001 Victorian Essential Services Commission Act (the ESC Act) and appeals may be made on the basis of:

- Bias; or
- Decision made on a natural error of fact.

However, even under these relatively restrictive terms four of the electricity distributors appealed against the 2001 Electricity Price Determination, on the basis of incorrect expenditure forecasts by the regulator. This involved sums of between $10 - $200 million over the five-year regulatory period. This clearly shows the value of effective and even limited appeal rights.

However, such appeals did not lead to any changes to the Code because the appeal panel, under the ESC, only looked at the issue of fact. Victoria has also limited the rights to judicial review of the regulator's determination which has further restricted the role of the Victorian courts in updating the Code. Under s.62 of the ESC Act:

> "No proceedings may be brought in respect of a determination or a provisional order or final order other than on grounds that –
>
> a) there was no power to make the determination or final order; or
>
> b) that the procedural requirements in relation to the making of the determination or provisional order or final order have not been complied with."[24]

These divergences in appeal processes under the energy codes undermine the goal of a nationally consistent energy regulatory regime. In addition, the Codes fail to adequately protect the private property rights of regulated companies.

[24] There are no clear requirements in the ESC Act that set out what such "procedural" requirements might be.

Appeal trigger mechanisms should be consistent

To be effective, appeal mechanisms must allow affected parties to trigger merits or judicial review when key decisions are made. Typically, regulatory decisions under the gas access regime involve a long period covering consultation through to draft report and final report usually taking some 12 months.

Although judicial review may be instituted (at least in some jurisdictions) at any time following a Draft Decision (as established by the Supreme Court in the Epic Energy case) full merits review of a regulatory gas determination can only be made in circumstances where the service provider has not made required amendments to their proposed Access Arrangements, leading to the regulatory authority imposing an Access Arrangement it has itself drafted.

In most cases access to administrative review is on the basis of a regulators final decision. This should be the appropriate point for all merit appeals. In addition, appeal rights should also be available for appeals that deal with revenue or pricing matters during the access period.[25]

Review Powers

A final element of an effective and efficient merits appeal arrangements is the capacity for an appeals body to implement its findings. To allow this, full merits appeal arrangements should allow the primary decision to be either:

- affirmed in full
- set aside to be remade by the primary decision-maker
- varied according to findings of the merits review body

For this to be possible, the merits review body should be in a position to exercise all the powers and functions of the primary decision-maker, and substitute its decision for that of the primary decision-maker. Such an approach could be modelled on the powers of the Australian Competition Tribunal although states may have to refer powers to use the current ACT.

[25] In gas and electricity distribution regulation there are some revenue and pricing issues that are determined by a regulator within the five-year regulatory period and the appeal processes should be extended to these matters as these can also relate to private property rights of distributors.

Recommendation 2

That the following principles be used on which to base legislation to implement a full merits appeal system into the National Gas Code:

Principle 1: **access to full merits and full judicial review for owners of gas distribution assets for price determinations and any other regulatory decision affecting revenue.**

Principle 2: **consistency or harmonisation of bodies responsible for conducting merits and judicial review between Commonwealth, State and Territory regimes.**

Principle 3: **consistency and clarity in the grounds for merits and judicial review between Commonwealth, State and Territory regimes.**

Principle 4: **an ability on the part of merits review bodies to set aside, vary, or substitute their own decision for that of the original decision, and to exercise all the powers and functions of the original decision-maker.**

Principle 5: **Access to the courts for judicial review on a matter of law should not be restricted.**

4.0 Regulatory Pricing Objectives and Market Power

4.1 Introduction

Given the establishment of a clearer set of objectives in the Gas Code it is also important to consider the pricing arrangements that should follow. The Code is currently based entirely on cost based models and regulators across Australia have used the 'building blocks' Cost of Service model to set access prices. While such models may be useful in the early stages of regulation when a utility may not have efficient costs it is doubtful that its use should be continued given the:

- costs and intrusive nature of the "building blocks" model;
- use of the "workable competition" model on which to simulate pricing decisions;
- changing nature of the industry with less firms being vertically integrated; and
- highly questionable need for continuing with cost based models when costs are likely to be efficient after the first use of the "building blocks" model.

A key economic principle in competition economics is that the level of regulation should be related to the ability of the service provider to exert market power. This principle has not been used in the Code to determine the regulatory approach and this is a major deficiency.

The criteria necessary to assess the significance of a firm's ability to exert market power include the:

- actual and potential level of import competition;
- significance and nature of barriers to entry in the market;
- degree of countervailing power in the market;
- likelihood that any monopolistic prices can be sustained in the long run;
- extent to which substitutes or alternative sources of supply are likely to become available;
- dynamic characteristics of the market, including growth, innovation and product development; and
- efficiency costs of sustained monopolistic prices.[26]

[26] Productivity Commission, Review of the Prices Surveillance Act 1983, Inquiry Report No. 14, 14 August 2001, p.89 for a discussion of these criteria. To the extent that monopolists can structure their price menus efficiently, so that prices are high for the inelastic segment of demand and low for the elastic section, there may be little distortion in supply and consumption patterns. Of course distribution effects may be present but the impact of these is more complex with share ownership and superannuation funds holdings. See also Gary Banks, Chairman Productivity Commission, "The 'baby and the bath water' avoiding efficiency mishaps in regulating monopoly infrastructure" Presentation to the IPART Conference, Incentive Regulation at the Crossroads, Sydney, 5 July 2002, pp. 5-6.

The form of regulation that should be applied will also depend on the previous forms of regulation the firm may have been subject to; the incentive properties of any new form of regulation the firm is proposing; and the legal decisions that clarify the interpretation of key provisions of the Code. In particular:

- A firm that has been through at least one "building block" cost of service reviews should have close to efficient costs and could move to a lighter handed non-cost based method of regulation;
- Non–cost based models such as Price Monitoring require limited monitoring of costs as a firm has an incentive to minimise costs; and
- The interpretation of the Code term "competition" to mean "workable" competition rather than "perfect" competition as set out in the EPIC case.

4.2 Should price monitoring regulation apply to Gas Distributors?

In the following section, we consider whether the Productivity Commission's use of price monitoring in regulating airport charges is also appropriate for regulating energy distributors.

Vertical separation

Multinet is not vertically integrated and as such has no incentive to refuse access. The Productivity Commission has used this reason in the review of airports to argue against the use of Access Arrangements to regulate airports[27]. It was also supported by the ACCC in its submission to the airport's review, which stated "

> "When a service provider is vertically separated it will usually have little incentive to deny access. While a service provider may exploit its market power by setting higher prices it is unlikely to manipulate other terms and conditions to limit access. Nevertheless the negotiate-arbitrate provisions allow an access seeker to seek arbitration over non-price terms and conditions. This could result in unnecessarily intrusive arbitration over detailed operational matters." (P.335 Review of Airports)

Lighter handed regulation is required for non-vertically integrated distributors because they have an incentive to maximise throughput, and this is a constraint on the exercise of monopoly power. Distributors are also required, under current rules, to connect customers on demand and this makes it difficult to exercise market power though control of production levels.

Light-handed forms of regulation could also be supported for those integrated companies who have adopted effective ring fencing operations such as separate management and boards for the various entities.

[27] There is a number of energy distribution businesses, which are not vertically integrated including United Energy, Citipower, Powercor and Envestra. Ring fencing can also be effective in simulating a position of vertically disaggregation.

Extent to which substitutes are available

Customers can make decisions regarding substitute products when selecting or updating their capital equipment or appliances. This is particularly the case with new extensions where households are choosing their energy source and can trade off costs and benefits of alternative sources of energy.

At any time this may affect some 7% of consumers who are new households or are replacing equipment and may provide some constraint on the exercise of market power in electricity or gas pricing.

The evidence is that aggregate gas demand is relatively responsive compared with other fuels to changes in its own price (with a long run own-price elasticity of demand of 0.78) and particularly sensitive to changes in electricity prices (with a cross price elasticity of demand of 0.82).[28] This supports the conclusion of a relatively high level of substitution between gas and electricity.

Changes in technology such as with small domestic gas fired electricity generators would reduce the ability of gas monopoly pricing, as these would become less competitive with electricity.

For firms whose energy costs are a large proportion of their cost structure, energy price differentials may have an important influence on the location of new capacity, obliging gas distributors to keep price increases within bounds. Many industrial processes can switch between different energy sources at short notice and this can also provide a constraint on the exercise of market power by gas distributors.[29]

Single energy suppliers such as Alinta would be subject to competition with other energy sources and these constraints on the exercise of market power should ameliorate the exercise of monopoly power.[30] However, to adopt price monitoring, vertically integrated gas companies may have to adopt a published open access policy such as Duke Energy has adopted on the Eastern Gas pipeline as concerns may still exist regarding access.

Degree of Countervailing Power in the Market

The issue of countervailing power is a complex one especially in an industry where distributors sell to retailers who bill end use customers. As noted by Professor King:

> The existence of a single significant buyer does not automatically create countervailing power To determine if countervailing power is relevant, the analyst needs to consider the bargaining position of buyers and sellers. In particular, it is important to consider which parties will lose most from any failure to reach an agreement to trade the relevant product. For countervailing power to exist in a market that otherwise is deficient in competition, any losses from a break-down in bargaining need to be predominantly borne by the seller.[31]

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28 Productivity Commission, Australian Gas Industry and Markets Study, 6 March 1995, p. 82-83.

29 Productivity Commission, Australian Gas Industry and Markets Study, p. 84.

30 For example gas competes with electricity, in particular with the electricity-heating tariff, which is generally relatively low as it is off peak. Unless gas distributors can connect two services (eg. cooking and heating) the consumers will not be profitable to connect.

31 Productivity Commission, Price Regulation of Airport Services, Submission by ACCC, p. 192.

There are several indicators of the relative strengths of the bargaining positions of distributors, retailers and customers. They include the following.

- Independent retailers attached to distributors could provide a countervailing power to monopoly price increase, especially if they were price capped;[32]
- Distribution prices flow through retailers and to final customers, all of whom can monitor and object to price increases and produce a countervailing power to monopoly prices; and,
- Even with an associated retailer a distributor would be constrained from increasing prices by larger customers, industry associations, lobby groups and the media. However, a company owning a retailer may need to give a voluntary undertaking on open access to be price monitored, as discussed above.

Under a system of Price Monitoring, the countervailing power of large firms and independent retailers to complain would moderate any exercise of market power given that such complaints could indicate an abuse of market power and perhaps cause price controls to be reintroduced. For these reasons, a price-monitoring regime should provide an effective control on a distributors market power, even where countervailing power may be relatively weak.

Firms Have Efficient Costs

The Productivity Commission has supported the idea that once a company had been through a Cost of Service "building block" review it could move to a more light handed pricing approach because its costs should be efficient:

> "In the position paper the Commission recognised on the complexities of moving to productivity-based approaches and, in particular, the issue of how to establish starting cost bases. However, it noted that as a result of past building block exercises, cost bases have already been established for most essential infrastructure in Australia. Thus, the Commission suggested that there would be significant benefits in taking advantage of this data and relying to a greater extent on productivity based approaches to capping prices for access to that infrastructure."[33]

Such an approach is also supported by the problems with the forward-looking nature of the "building blocks" pricing approach. Distributors are uncertain on forward-looking capital and operational costs given their requirements fluctuate with the weather and the change in the structure of the economy. For example, a wet year will involve a significant increase in gas operations and maintenance costs as low-lying areas can get flooded. Weather has become less certain since the late 1990's and this has made the forward-looking cost model less appropriate as a basis of price setting.

[32] Two original independent retailers were stapled with Multinet's distribution area and new retailers also operate.

[33] Productivity Commission (September 2001), p. 346.

Multinet and other Victorian gas distributors have also been assessed as efficient on the basis of various benchmarking techniques such as partial analysis, Data Envelope Analysis and Econometric Cost Modelling. In short, the Victorian gas distributors have been subjected to two detailed costs of service reviews over the past six years and they were found to be efficient in the first review. Given this data, the ongoing use of the costs of service approach must ensure that the costs of regulation exceed the benefits. A price monitoring approach would provide a means of strengthening the incentives for distributors to deliver services that meet customers' needs in an efficient manner over the long term, whilst minimising the costs of regulation.

Workable Competition and Pricing Approaches

The full bench of the WA Supreme Court in the EPIC case determined for the first time that when the word "competition" is used in the Gas Code it means "workable competition" rather than the "perfect competition" model used by regulators currently.

The Court argued that a "workably competitive' market might well tolerate a degree of market power, even over a prolonged period and that the recovery of efficient costs in the context of a "workably competitive" market may be higher than in a "perfectly competitive" market.

The Court in para 143 and 144 stated that:

> "… As far as the expert evidence discloses, a competitive market in the sense of a workably competitive market appears to be viewed by the general body of economic opinion as likely, over time, to lead to economic efficiency or at least to greater economic efficiency. As the Hilmer Report puts it, the promotion of effective competition is generally consistent with maximising economic efficiency. This would suggest that, over time, the revenue earned by a service provider from a reference service, if that service was provided in a workably competitive market, would approximate the efficient costs of delivering the service. That also helps to confirm that the concept of efficient costs, like the outcome of a workably competitive market, is not capable of precise or certain calculation and at best, can only be approximated."

And 144:

> "In particular, at the time of the Hilmer Report, it was recognised that economic theory offered no clear answer to how bets to resolve many competing considerations, including how to achieve the most appropriate balance between the interests of consumers in obtaining low prices and the service provider in receiving high prices, including monopoly rents, that might otherwise be obtainable (Hilmer p. 253). It was noted however, (Hilmer p.269) that where the conditions for workable competition are absent, firms may be able to charge prices above the efficient level for periods "beyond those justified by past investment risks taken", it being a primary goal of competition policy to increase competitive pressures in such situations. It appears to be inherent in this that in a workably competitive market past investments and risks taken may provide some justification for prices above the efficient level." [34]

[34] *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [143 & 144].

The performance of a "workable competitive" market includes efficient production, no excessive costs, profits just sufficient for investment and innovation, responsiveness to consumer demands, technical progress and success accruing to those who best meet customers' needs. The conduct criteria require uncertainty about rival's response, no collusion, no anti-competitive tactics, no permanent inefficiency, no misleading sales promotions and no harmful price descriptions.[35]

4.3 Conclusion

Whilst there are some differences between the airports and energy distribution, particularly in terms of the availability of effective substitutes, the above discussion shows that there are no impediments to regulators adopting a system of price monitoring for energy distribution. Moreover, the discussion above emphasizes that there is a strong case to question the ongoing application of a detailed "building blocks" approach given that:

- Victorian gas distributors have now been subject to two costs of service reviews in six years by the independent regulator; and accordingly;
- costs and overall revenue requirements of those businesses are efficient.

Price monitoring is more consistent with a "workably competitive" market that stresses commercial negotiation. Greater commercial negotiation is also necessary in markets to ensure the cost-effective dynamic investment is there to upgrade networks to service levels consistent with a more technological advanced society. Greater customer interaction would involve retailers and distributors working with customers to develop efficient and effective price service offerings. However, this may require some further consideration given that distributors are likely to have longer term incentives compared to retailers who may have a much shorter term focus.

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

A key principle in the reformed Gas Code should be a requirement that the costs of regulation should not exceed the benefits and that there should be some criteria for assessing the pricing options available to a regulated company at a point in time. This suggests that the criteria should be related to the firms ability to exercise market power and the ability of the pricing regime to minimise the exercise of market power.

In the next section, we consider how price monitoring would apply in practice.

[35] Stephen Littlechild, Assessment of Price Service Offerings, Final Report for Energex, 4 December 2002, p.109.

Recommendation 3

Pricing objectives should be implemented in the reformed Code and these should include the following:

- **The cost of regulation should not exceed the benefits.**
- **The price controls of regulated distribution utilities should be linked to their ability to exert market power and to the ability of the regulatory regime to minimise the likelihood that market power will be abused.**

5.0 A Price Monitoring Model for Gas Distributors

5.1 Introduction

The key features of a Price Monitoring Regime are:

- Annual reporting of prices, costs and profitability;
- Annual reporting of service standards;
- A review of the effectiveness of the monitoring regime after five years of operation and earlier if anti-competitive behaviour or exploitation of market power has been exhibited during the term of the monitoring period.

Price monitoring can broadly perform two functions as:

- an instrument of regulation and compliance by a regulator; and
- a means of observing and understanding the performance of a firm.

In some situations there may be a concern about market power in an industry. Monitoring provides a means of observing and understanding the performance of the firms and the industry. It facilitates the systematic disclosure of information not readily available from other sources. For example, it may collect, publish and report on segregated company results and key indicators of performance such as prices for certain classes of customers or users, profitability and quality. The monitoring report provides information to the public and policy makers. However, it is not intended to be used to directly regulate behaviour.

The model proposed below is largely based on the proposals adopted by the Commonwealth Government for regulating airports following the Productivity Commission's Review of Airport Services.

5.2 Issues in Regulation by Price Monitoring

In order to achieve the appropriate balance between greater flexibility for the firm and the chance that the firm will exhibit anti-competitive behaviour, key issues in the design of a price-monitoring regime are specification of the:

- information to be disclosed (to assist in determining whether market power has been abused and also to promote informed commercial relationships); and
- nature of the 'threat' or over-arching constraint on abuse of market power, including in what circumstances action can be taken and the form that action will take, in the event that the supplier exploits its market power.

If these elements are not clearly spelt out, there is a risk that light-handed regulation could become ineffective or become as intrusive as stricter price controls. The threat to regulate may well be much the same as actual regulation. The regulated firm does not know what behaviour on its part will induce the regulator to reintroduce price controls. For example, if the firm earns high profits, the regulator may intervene. If regulated companies expected this outcome, this shadow regulation would have the same effects as cost plus regulation. The incentive to keep costs at a minimum would be weak, since lower costs and higher profits will result in price controls being re-imposed. The inefficiencies created by cost-plus regulation may also be present with this shadow regulation if it is not correctly structured.

The Use of Public inquiries

Reviews of the market before price controls are introduced and after a period of price monitoring are important aspects of ensuring the most appropriate regulatory model is chosen. A public inquiry provides a systematic process for gathering, assessing and disseminating information about particular pricing issues or problems. The Hilmer Committee proposed that:

> "… firms should be subject to prices oversight in only limited circumstances defined by statutory criteria and after an independent inquiry has investigated the market situation, alternative pro-competitive reforms and recommended that prices oversight is appropriate" (Independent Committee of Inquiry 1993, p. 273).

A review at the conclusion of the price-monitoring period could take into account changes in the environment in which the regulated entity operates and the behaviour of the various parties during the monitoring period. Information collected through monitoring could form part of that assessment.

A review determines the success of the regulatory regime and a successful outcome for the firm is a continuation of the monitoring regime. The test of success is that there is no abuse of market power evident in the five years of price monitoring.

Triggers for Stricter Regulation

The potential for inefficiencies may be alleviated to some extent by defining the behaviour on the part of the regulated firm that would trigger stricter forms of price regulation (or the 'acceptable' behaviour that would *not* trigger stricter regulation).

However, clearly defining such behaviour may be difficult — high prices may be a signal that new investment is required rather than an indication that monopoly prices are being charged; high profits may reflect entrepreneurial skills rather than market power, and increases in prices may simply reflect changes in costs or that prices previously were too low. This suggests that a broad set of principles is likely to be preferable for guiding efficient behaviour to specific criteria that if applied in isolation may not be consistent with efficient outcomes.

Specific criteria for triggering regulatory intervention could also encourage strategic behaviour. If a customer thought that strict price regulation may be re-introduced during the term of the 5 year monitoring period they may attempt to game the system in the expectation of receiving a lower price through the reintroduction of price controls.

If it were made clear that any such regulation would not be reintroduced within a predetermined period, there would be less potential for the undermining of *bona fide* commercial negotiations through gaming. However, if a within-term threat of a trigger for the return of price controls is used it is important that the terms of the review for the within-period review should be the same as the approach at the end of the period review.

A review at the end of the regulatory period would assess whether stricter forms of price regulation, further monitoring, or any other action were warranted. The monitoring period would need to be long enough to encourage commercial negotiation, but not so long that the threat of reintroduction of stricter forms of price regulation was not an effective deterrent against abuse of market power.

While the regulator is likely to have expertise in analysing monitoring information, as a matter of principle it would be desirable to separate policy and regulatory roles by having any review conducted by an independent body. Such a position was strongly supported by the Parer Energy Review in terms of code change processes. The Commission in the Airports Review also recommended that the review should not be undertaken by the regulator but by a qualified third party.

Information disclosure

The effectiveness of a monitoring regime also would depend on whether disclosure of information was mandatory or voluntary. Although the compliance costs of voluntary disclosure may be lower, a legislative requirement for disclosure could help ensure compliance and allow monitoring of information that is not publicly available.

Comprehensive requirements for disclosure that are spelt out clearly at the start of the monitoring period, and not altered, may help to minimise regulatory creep. Although there may be occasions when it is desirable to vary disclosure requirements or seek further information, doing so may increase compliance costs and regulatory uncertainty.

Information that could be disclosed under a price monitoring regime includes prices (contracts or general), revenues, the level and incidence of operating and capital costs, various measures of profitability, service quality and productivity. The disclosure of such information may:

- help in assessing whether any market power is being abused;
- facilitate comparisons of monitored variables between regulated companies (and potentially within Australia, and between Australian and overseas companies); and
- improve negotiation between users and regulated companies.

Compliance costs of monitoring

The compliance costs of monitoring should be lower overall than the compliance costs associated with the current regulatory arrangements. However, the compliance costs of regulation will be reduced where the information required for monitoring is less detailed and its analysis by the regulator less complex than for price caps.

5.3 Review of the Price Monitoring Scheme

If success is judged in terms of ensuring that there is no abuse of market power in the five years of the price-monitoring scheme how can this assessment be undertaken?

The following principles should be included:

Pricing principles:

- Prices should broadly generate expected revenues that are consistent with the long-run costs of efficiently providing the energy services in the context of a “workably competitive” market;
- Price discrimination and multi-part pricing that promote efficient use of the network should be encouraged.

Other principles:

- Whether quality-of-service outcomes have deteriorated and/or failed to meet the requirements of users; and
- The extent to which commercial agreements on prices and quality of service have been negotiated.

The Commission in the Airports Review also determined that the Review could also be assisted by the development of voluntary agreements between airports and users which could be lodged with the regulator and which would show:

- Agreed terms and conditions (including prices) of airport use, including the services provided, service quality and information provided by the parties;
- Dispute resolution mechanisms (eg. the scope for independent arbitration);
- The period covered by the agreement; and
- Consultation and other procedures to be followed to vary the agreement.

However, the Commission recommended that acceptance of lodgement would not involve an assessment by the regulator of the prices, terms or conditions agreed between the parties. The Commission's approach is to clearly establish a set of incentives to limit the prospect of an abuse of market power.

Recommendation 4

In recognition that a Price Monitoring regime encourages greater commercial negotiation and dynamic investment, and reduced direct and indirect regulatory costs, price monitoring arrangements based on the Airports model be permitted for gas distributors that:

- **Are not vertically integrated or effectively ring fenced with an open access public commitment;**
- **That would have difficulty in exercising their market power; and**
- **Have been through at least one "building" block review.**

The performance of the price monitoring scheme should be reviewed with reference to the principles outlined above, five years after its introduction.