

## **Submission to the Productivity Commission Draft Report on the Gas Access Regime**

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This is a brief comment on the Productivity Commission Draft Report on the Gas Access Regime. The objective of this comment is not to criticise the work by the Productivity Commission but rather to provide a way forward.

It is important to recall that this review was commissioned with three specific aims: (a) to analyse the benefit, costs and effects of the regime, particularly on investment and competition; (b) to consider any improvements; and (c) to identify and investigate the appropriateness of including in the Gas Code minimum price and non price requirements.

We start by summarising the main points of the draft report. The Productivity Commission finds that continuation of the current Gas Access Regime is warranted, but that a less costly monitoring option should be introduced. It recommends that the Gas Access Regime be improved by clarifying objectives and strengthening the threshold tests for coverage and price regulation. The Commission notes that the current regime deters and distorts investment. Further, the Commission proposes that disincentives to invest in new projects could be reduced by a regulation free period of 15 years in some cases.

Before we address findings and recommendations of the report, it is worth emphasizing that regulation is by nature imperfect. The basic trade-off from the viewpoint of society is between imperfect markets and imperfect regulation. That is, it is not possible to design a regulatory framework that produces precisely the outcome of perfectly competitive markets. The very existence of asymmetric information, sunk costs, large lumpy investments and economies of scale that render perfectly competitive outcomes unachievable also render perfect regulation unachievable.

We now turn to the Commission's main recommendations. Our starting point is to recognise that regulation creates uncertainty almost by design. It is not

possible to design a regulatory framework that will map perfectly all possible outcomes to possible regulatory decisions. However, some of this uncertainty is unnecessary. An example of unnecessary uncertainty is that resulting from too broad and too vague conflicting objectives. Thus, we fully support the Commission's recommendation of inserting an overarching objects clause with a focus on promoting efficiency and removing inappropriate objectives. Of course, although conceptually important, such a change in objectives is unlikely to have any immediate effect on reducing uncertainty unless tested by the courts. More important are the proposed changes on coverage and the proposal of an access holiday for new investments.

Let us now discuss the Commission's conclusion that the current regime deters and distorts investment. This conclusion is essentially the justification for the introduction of a less costly form of regulation.

The Commission notes that it is difficult to 'draw conclusions about the effect of the Gas Access Regime on investment based on the information provided by inquiry participants.' Not surprisingly, service providers offered examples of investments that were not pursued as a result of the access regime whereas users and regulators provided circumstantial evidence of investments being pursued. Given that the Commission could not measure one set of evidence against the other, it made a decision to take as given that the access regime affects investment based on correct conceptual issues. We obviously agree – economic theory supports the view that unless the prices are set correctly, investment will be affected. Moreover, given the imperfections (asymmetric information, etc.), the probability of the regulators setting the right price is effectively zero. However, we do not think that this is the right question to ask. The right question to ask is by how much investment has been affected by the access regime. This is an empirical question that deserves an empirical answer. The reason this is the right question to ask is that if it turns out that the effects on investment have been substantial then we would need to think about a more substantial change to the regime. On the other hand, if it is found that the impact is negligible then it may be that it is sufficient to change the objectives, introduce access holidays and postpone the decision to roll back regulation.

We understand the hesitation on the Commission's part to tackle such a question: the main difficulty being determining what would have occurred in the absence of the regime. This is a difficult but not impossible task. This is a question that those working in antitrust economics have to face on a daily basis – comparing the future with a particular transaction (the factual) with the future without the transaction (the counterfactual).

There are different possible approaches such as using international or intermarket benchmarking. There are existing databases on regulatory regimes and some investment data available for OECD countries that can be used. Another approach is to estimate investment functions (See, for example, "Regulation and Investment Behavior: Evidence from the Electric

Utility Industry,” Lyons, T. P. and J. W. Mayo, George Stigler Center for Studies of Economy and State Working Paper 128, 1996). Of course, these approaches are plagued with faults and shortcomings.<sup>1</sup> However, given the significance of the potential results, we believe that such a study would be a valid use of the Commission’s resources. The general argument is that the remedy has to be proportional to the disease.

*Recommendation 1: The commission should pursue an independent objective investigation into the effects of the access regime on investment.*

Another reason why we think an answer is needed is that we are sceptical about monitoring options. Our main concern is that if a strong case for or against regulation is not made, a monitoring option might end up being as intrusive as price setting and less transparent. Thus, one might end up with a perverse case where monitoring increases regulatory uncertainty. This uncertainty is compounded by the imprecise nature of the distinction between increasing competition to a material degree and increasing competition to a substantial degree. As with the current regime, the main sources of inefficiencies arise from the marginal projects.

*Recommendation 2: The monitoring regime needs to be spelled out in greater detail and, in particular, its advantages vis-à-vis the general protection conferred by Part IIIA of the TPA.*

On the issue of the introduction of access holidays, we support the proposal that pipelines without market power should qualify for a set regulation free period. While it is argued that a fixed period may be preferred to a period set on a case-by-case basis, there is little discussion of the length of the term. In fact, the final comment in the discussion of the term is that some providers claim that 20 years would be more suitable. This claim is not tested, nor the case where a shorter term may be more suitable. The argument would be strengthened by a discussion of the costs of imposing a fixed term in those cases where a different term would be optimal. While the proposal for a 15 year term has been argued in other forums, there is no discussion of how the choice of 15 years was arrived at.

*Recommendation 3: The commission should provide a more thorough discussion of how the choice of 15 years was arrived at.*

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<sup>1</sup> One of the issues is that for local gas distribution lines, investment is typically mandated by service obligations. As a result, regulatory decisions might not immediately reduce investment.

Finally, it is our judgement that there is sufficient ambiguity regarding the effects of the current access regime on investment and competition that it would be very risky to completely scrap the Gas Access Regime at this point in time. However, it is important not to forget that a more direct regulatory approach, with regulators effectively setting prices as in the current access regime is only a means to an end. This can only be justifiable as a transition to a stage where there will be sufficient competition that direct regulation will be no longer necessary.

*Recommendation 4: The final report should reaffirm the transitory nature of the price setting arrangements.*