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Economic Regulation in Western Australia

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Introduction

Thank you for the invitation to speak to the Perth Branch of the Australian Institute of Energy. This is the first opportunity I have had to speak publicly since I was appointed in March this year. There are two points I need to emphasize at the start of my presentation.

First, I am not the Authority. The Authority consists of myself and two part-time members, Ken Michael and Chris Field, and the views and decisions of the Authority are taken collectively. Therefore the views I express today should not necessarily be taken to represent those of the Authority.

This leads to the second point. Speaking publicly as the Chair of the Authority is a difficult role. A representative of an independent regulator cannot be seen to be prejudging an issue on which the regulator might be asked to make a decision. I know Ken in the past has been very conscious of the need to be careful in public comments not to open up any basis for a perception of bias or prejudgment of an issue. On the other hand, I think it is reasonable that as the Chair of the Authority I express a public view on how I see the role of the ERA, or, as the occasion demands to explain the decisions of the regulator, or to make factual comments on issues related to the role of the ERA, or to participate in public debates about economic regulation while recognizing that at the end of the day we (the ERA) will have to operate within the legislation, regulations and codes we are given and to do so without fear or favour. I am sure you would wish to hear more today than a bland description of what the ERA does.

In any case, I take some comfort from the words of the 18th Century German philosopher, Friedrich Heinrich Jacobi who reportedly said:

> *"To lay aside all prejudices, is to lay aside all principles. He who is destitute of principles is governed by whims."*

I am sure no-one in this audience wants a Chair of the ERA who is governed by whims – think of the regulatory risk!

What I would like to do in the time available is to look briefly at the role of the ERA, to look at why we have economic regulation and finally to look at the experience of, and issues facing economic regulation. I hope you will bear with me, there is a lot I want to say and I didn't have time to write a short speech!

Economic Regulation Authority

Let me very briefly turn to the role of the ERA. The governing body of the ERA consists of three members, myself as full-time Chair and two part-time members - Ken Michael and Chris Field. Ken would be very familiar to this audience as the previous rail and gas regulator prior to the establishment of the ERA. Chris is Executive Director of the Consumer Law Centre of Victoria and National Chair of the Australian Consumers Association. Chris has also had considerable experience in the area of economic regulation as a representative of consumers on a number of bodies providing advice to the Essential Services Commission in Victoria and the ACCC.

The ERA administers industry specific legislation in the area of gas, rail, and water and from July 1 this year, electricity. In undertaking this role the ERA is independent of both industry and Government – the ERA cannot be subject to State or Ministerial direction with regard to its regulatory functions.

The ERA is responsible for regulating access to rail, gas transmission and distribution pipelines (where they are "covered"), and from July 1, electricity transmission and distribution lines (in the SWIS). The ERA is also responsible for the licensing and performance monitoring of water and gas service providers, and again from July 1 this year, electricity service providers.

The ERA has also been provided with an inquiry function. The State Government can provide the ERA with references to inquire into matters related to the regulated industries or non-regulated industries. In this role, the ERA would undertake a public consultation process (including the release of a draft report) before presenting a final report to the Government. In this role the ERA is not a decision maker – what the Government does with the report is up to the Government although the Minister must cause a copy of the report to be laid before both Houses of Parliament. It is similar to the role the Productivity Commission plays at the Federal level. The State Government has already indicated publicly that it will be giving the ERA a reference to inquire into the appropriate structure and level of urban water and wastewater prices and we are expecting to receive that important reference in the very near future.

The ERA is subject to a range of legislation. The *Economic Regulation Authority Act 2003* provided for the establishment of the ERA and for the reference function I just mentioned. In the gas area there are two Acts – *Energy Coordination Act 1994* for gas licensing and the *Gas Pipelines Access (WA) Act 1998* for gas access. Rail access is governed by the *Rail (Access) Act 1998*. The ERA's role in water licensing is governed by the *Water Services Licensing Act 1995*. Finally, electricity access and licensing arrangements are governed by Electricity Industry Act 2004, which is waiting to be proclaimed.

In undertaking its role, the ERA (under the ERA Act 2003) must have regard to: the need to promote regulatory outcomes that are in the public interest, the long term interests of consumers, the need to encourage investment in relevant markets, the legitimate business interests of investors and service providers, the need to promote competition and fair market conduct, the need to prevent abuse of monopoly or market power and the need to promote transparent decision-making processes that involve public consultation.

As an aside, I think I can still remember enough of my economics training to think that parliament might have been able to provide better direction through the addition of an overarching objective which would set the context for the matters the ERA is required to take into account. It is interesting to note that in its draft report on the review of the gas access regime the Productivity Commission suggested an overarching objects clause be included in the following terms:

> *"To promote the economically efficient use of, and investment in, the services of transmission pipelines and distribution networks, thereby promoting competition in upstream and downstream markets."*

There are also a range of requirements in the industry specific legislation that the ERA is required to take into account when considering specific industry matters.

The current organization structure is set out in Attachment 1. This will change when the ERA assumes responsibility for electricity regulation. You will note that while retaining specific expertise in each of the industry areas, we are also seeking to take advantage of issues that are common through the use of pooled resources (as well as helping to eliminate the potential for industry capture!).

Attachment 2 sets out the regulatory structure. You will note that in addition to the General Manager, each of the industry Directors can make direct submissions to the Authority.

Let me now turn to my second area of discussion.

Why Have Economic Regulation?

There is a particular quotation that I like and that I used quite often in my role at CCI. It contains an appropriate warning for those of us who get involved in public policy. It is by the "father" of modern economics, Adam Smith, who was an 18th Century Scottish moral philosopher. He said in his book *The Theory of Moral Sentiments*:

> *"The statesman who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted to no council and senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it."*

It is a useful quotation to remember when considering any form of regulation.

The general argument for regulation revolves around some form of market failure. Focusing on essential infrastructure the market failure is a lack of competition which gives rise to market power and the fear that such market power will be exploited to the detriment of consumers and leading to a misallocation of resources.

However, while the presence of market failure is a necessary condition to justify the use of regulation, it is not sufficient. When considering regulation one should be aware of the dangers – inevitably you are interfering with property rights and acting through edict not voluntary exchange (see Adam Smith).

A good intention (to overcome market failure) is not enough. There is ample evidence that regulatory failure can be just as common as and potentially more damaging than market failure. And regulation is not costless – there are administrative costs, compliance costs, and the wasteful use of strategic resources. Even if an assessment of the potential benefits outweighs the potential costs, this is still not enough.

The introduction of regulations can only be justified if the regulation will lead to a better result (better allocation of resources) than doing nothing and accepting market failure and it does so in a way that is better than any alternative approach. Regulation is not an exact science. It will be imperfect and we need to be conscious of the short and long term impacts and the dynamic impacts, both intended and unintended. The regulatory "hurdle" needs to be a high one!

In the case of the ERA, we are dealing with essential infrastructure with natural monopoly characteristics. The market conditions mean that it is likely that one provider will be best able to provide the most efficient delivery of services. This is because there are declining marginal costs over the relevant market size (economies of scale) or that a single provider will have lower marginal costs over the relevant market size (economies of scope) compared to the marginal costs of two or more providers. One provider means no competition and the potential for abuse of market power. In this case, there are two reasons to regulate – to ensure access and/or to manage monopoly power.

The issue of access can arise if the infrastructure owners have a potential conflict of interest because they are involved in either upstream or downstream activities. It could be in the owners' commercial interests to restrict access to the infrastructure by potential competitors in upstream or downstream markets. The best option would be to eliminate the conflict so that the commercial interests of the owners are to maximize the use of the infrastructure (although the issue of monopoly power is still an issue). The DBNGP and the GGP (although now complicated by the Alinta purchase of Duke assets) come close to eliminating conflict while Western Power is a clear example of the potential conflict. The second best option (if the conflict remains) is to regulate access (including ring-fencing arrangements).

The second reason to regulate is to manage monopoly power. A firm with monopoly power in attempting to maximize profits will raise prices and restrict throughput to a level less than consistent with an efficient allocation of resources. Both users and the economy as a whole lose out. These higher prices may not necessarily reflect higher profits, it can also mean that there is a reduced incentive for the provider to behave as efficiently as possible and therefore may have higher costs than would occur in the face of competition.

There is some evidence that this was the case for infrastructure in public ownership where the incentive to maximize profits is perhaps not as high (despite the vigilant efforts of a Treasurer to maximize state revenue). There is some evidence of this in the case of Alinta where it appears that considerable cost savings were able to be made by the new owners after privatisation.

Having discussed the reasons why we have regulators, let me now turn to look at some of the experiences of, and issues facing infrastructure regulators. This is risky ground and a wise regulator would probably conclude at this point for I am sure that there are many in this room who would agree with the comments of Productivity Commission Chair Gary Banks who said:

> *"Regulatory price setting might be likened to sausage making – inquiring into the details of the process does not encourage confidence in the final product."*

I am sure he was not talking about WA made sausages……..or WA regulators!

DBNGP and Epic

Let me turn first to the DBNGP and Epic – I am sure you would be disappointed if I didn't. I was not involved in the decision made by the regulator, however I have carefully reviewed it particularly since taking on this new role. Let me say at the start that I am of the view that the regulator has been unfairly criticized, that I don't believe that an objective assessment of the circumstances could lead to a conclusion that this case should create a perception of regulatory risk in WA and, finally, I don't believe the regulator should carry the blame for the commercial circumstances Epic now finds itself in.

Let me repeat the comments I made in a recent letter to *The Australian*. It is not the role of the regulator to turn good commercial decisions into bad ones. Equally, it is not the role of the regulator to turn bad commercial decisions into good ones. Neither result would be in the public interest. It seems to me the debate over Epic revolves around two main issues – did the regulator overturn an agreement on price and was the price paid by Epic a good commercial decision?

All the information I am about to comment on is on the public record. For those who want more information I encourage you to read Ken Michael's Final Decision of May 2003 (it is on the ERA website). Some of the public commentators on this matter appear not to have read the decision!

It seems very difficult to make the case that there was an agreement between Epic and the State about tariffs that would apply after the regulator was established. Neither Ken Michael as regulator nor the WA Auditor General could find evidence of any such agreement. The WA Supreme Court found that at the time the regulator made his draft decision there was no evidence before the regulator of a "regulatory compact" nor any legally binding tariff agreement between Epic Energy and the State of Western Australia as a result of the DBNGP sale. The then Minister for Energy, Mr Barnett, told State parliament in June 2000 "the Government does not have any agreement with Epic Energy about transport charges". Mr Barnett (as Leader of the Opposition) in a public submission to the regulator in September 2001 said "With respect to the so-called "regulatory compact", no such explicit or implied arrangement has ever existed. It was quite clear prior to and during the sale process that bids would be set against a pre-determined schedule of declining transport tariffs to 2001(sic) and thereafter the transport tariff would be set by an independent regulator in accordance with the National Access Code". Finally, the Managing Director of Wesfarmers, Mr Michael Chaney is on the public record as saying "I think the government's absolutely right and I think the people who bid for that pipeline initially were fully aware of the regulatory conditions. They were all very clearly set out. If you departed from that, I think you raise a real issue of sovereign risk. That is, you achieve certainty by proceeding the way all of us expected it to proceed, not by changing the rules."

The second issue is - was the price paid by Epic a good commercial decision? I make three points. First, the regulator after examining the issue in great detail, including having access to all the confidential information concluded that it wasn't. (Again, it is worth reading the Final Decision to get a full understanding.) Second, there is a view in industry that Epic paid too much – with a range of figures being put forward as to by how much. The regulator in his Final Decision said *"Epic Energy's contention that the second highest bid for the DBNGP was 7.5 percent less than the Epic Energy bid is incorrect. I have examined all of the final bids made for the DBNGP. I note that all of the other complying bids were lower than Epic Energy's bid by amounts well in excess of*

7.5 percent". Third, the Gas Pipeline Sales Steering Committee commissioned PricewaterhouseCoopers (PWC) to provide an estimate of an Initial Capital Base (ICB), based on a Depreciated Optimised Replacement Cost (DORC) that might be used by a regulator in setting tariffs in the future. This work was part of the sales information made available to all bidders to assist in preparing their tenders. The DORC estimated by PWC was $1,124 million which adjusted to December 31, 1999 equates to $1,234 million. The regulator's final decision set an ICB at December 31, 1999 of $1,550 million.

It is also worth noting that PWC gave a range of tariffs for the full-haul to Bunbury and Perth of $0.71/GJ to $1.12/GJ as possible, and suggested "that values between $0.88/GJ to $0.98/GJ could be argued". This compares with the regulator's Final Decision which suggests a full-haul tariff of $0.95/GJ at 1 January 2000. This casts doubt on any suggestion that the regulator's final decision should have come as a surprise to any of the bidders.

It appears to me that there has been a concerted effort to try and shift the blame for a bad commercial decision onto the regulator.

It is also instructive to look at the counterfactual case – what would Epic have done to tariffs in the absence of the regulator? It seems reasonable to assume that it may have proceeded with what was proposed in the access arrangement submitted to the regulator by Epic. On the basis of the ICB proposed by Epic (based on its purchase price of the DBNGP) and Epic's proposed weighted average cost of capital (WACC), this would have implied a tariff to Perth of $1.41/GJ and $1.62/GJ south of Perth. This compares with the government regulated tariff (prior to the regulator) of $1 to Bunbury. (To make matters worse, Epic's tariffs relate to a service that is in the nature of a "no frills" service and that, through more onerous take-or-pay provisions, transfers a significantly greater risk to users. The $1 to Bunbury service that I referred to earlier was in the nature of an all inclusive service and had a take-or-pay provision of 72% as compared with the more onerous 95% demanded by Epic. In a nutshell, Epic sought a higher price for a lesser service and that leaves the user carrying a greater risk.)

As a final comment on this issue, I wonder what would have been the reaction if the regulator had simply allowed tariffs to be set at a level to justify a bad commercial decision and what precedent that would have set?

Regulatory "Chilling" of Investment

There is a view that the decisions of Australian regulators have had a "chilling" effect on infrastructure investment in Australia. Such discouragement to investment could occur for two reasons – the presence of regulatory risk and the regulator applying non-commercial rates of return in setting tariffs.

Regulatory risk relates to any uncertainty created by the approach taken by regulators. Yet it appears to me that there has been a very consistent approach taken by regulators across Australia and in WA. Any potential provider of proposed new infrastructure should be able to predict with a considerable degree of certainty, and within fairly narrow ranges, the approach likely to be taken by the regulator. Determination of ICB's and WACC's shows a large degree of consistency by Australian regulators. (While there is some debate over determining the ICB for existing infrastructure when first subject to regulation, the approach likely to be taken to new infrastructure is much more certain.) There could be even greater certainty by changing the Code to allow the regulator to give an up-front authorization of the WACC and the ICB, but given the consistency of approaches this should not be a big issue.

Regulatory risk can also relate to the rules being changed after an investment is committed. This has been one of the criticisms of the Epic case, but I have already demonstrated why I think that criticism is unjustified. However, the issue is a real one and could adversely impact on future investment. This is one issue that the ERA will need to address in its revised draft decision for the Goldfields Gas Pipeline.

The other way in which efficient investment could be deterred is if the regulators applied non-commercial rates of return. While this has often been expressed, there is little hard evidence that the rates of return used by regulators are unfair. For example, see the report by the Allen Consulting Group which was included as an appendix to the ACCC's submission to the Productivity Commission's Draft Report on the Gas Access Regime. While there are some investors who have lost money on infrastructure investments, this appears to relate more to the inflated prices paid for the assets. There appear to be buyers for existing infrastructure as well as investors for new infrastructure under the current regulatory regime, for example, Alinta's recent investment in the Duke assets. If the rates of return used by regulators were discouraging efficient investment that would be a major concern, but the debate around this matter needs to be based on more than unsubstantiated assertions.

The Use of Lawyers

Let me turn now to another issue. Although I have only been with the ERA for three months I am thinking of making one of our KPI's, a reduction in the amount we spend on lawyers! I think I have read more legal opinions in the last three months than in the rest of my working life to date!

There is a serious issue here. There is a risk that an overly legalistic approach by any of the parties, including the regulator, can remove the flexibility of parties to respond to issues, potentially lock them into positions that may be detrimental to all and cause unnecessary delays to the process.

This is not to suggest that good and proper process should not be followed. A failure to adhere to good administrative process carries severe penalties in terms of who wears the costs and the sheer embarrassment and impact on the perceived professionalism of an organisation.

I hope I am not being too naïve in raising this issue. I am well aware that there are cases where it is in the interests of the provider to delay the implementation of a new access arrangement as long as possible. There is also a large amount of money involved in these projects and lawyers costs (as large as they are) can seem insignificant in the context of what is at stake. Indeed, some would argue that given the sums of money at stake, it is almost inevitable that lawyers will become involved. However, while it is important that a regulator be consistent in its approach (to avoid either the perception or the substance of regulatory risk) there is also a need to look for practical, efficient outcomes which is not always helped if the first reaction of the parties is to turn to their lawyers.

This is an area which will require the assistance of all parties, including the ERA, but with some goodwill, frankness and openness, better outcomes, certainly in terms of timeliness, may be achievable. There is a need to recognize that to a considerable extent the regulator has to respond to actions initiated by the proponent and if the proponent wants to take an issue in a particular direction it limits the regulator's options.

New Infrastructure – Regulatory Holidays

Let me turn now to the proposal by the Productivity Commission in its draft Report on the Gas Access Regime for regulatory holidays for new investment. I have already expressed doubts about whether or not infrastructure regulation is deterring efficient investment. However, infrastructure investment is important and my own view is that there are conditions under which new infrastructure investment could be given a reprieve from unnecessary regulation.

If the investment is built under a competitive tendering process (to ensure it is built at an efficient cost), if there are significant foundation customers purchasing a significant part of the capacity (so that there is significant competition in setting foundation contracts), if there is limited conflict of interest for the infrastructure owners either upstream or downstream (to encourage maximum use of the infrastructure) then the need for regulation should be significantly reduced at least in the short to medium term. How long is the medium term is an important question and in my view could be assessed each time on the particular circumstances of the proposed project.

Technology Changes

There is one final issue I would like to discuss. There is an interesting book (certainly for regulators) published last year by the Cato Institute written by Adam Thierer and Clyde Wayne Crews Jr. The title of the book will give you an indication of its message "What's Yours is Mine: Open Access and the Rise of Infrastructure Socialism". It talks about the dangers of what it calls "forced access" rather than open access and the dangers that can arise from interfering with property rights, particularly the possibility of stifling innovation.

It makes what I think is a valid point and one worth remembering - technological change and innovation can mean that what is monopoly infrastructure today may not be in the future. An example would be Pay TV which was once the province of cable but cable now competes with satellite. An example in the future could be that if the efficiency of electricity generation units change so that smaller units can compete then it is possible that transmission, and perhaps even distribution, lines will lose their monopoly status.

The book reminds us that

> *".....competition in the creation of networks is as important as competition in the goods and services that get sold over new or existing networks."*

I think this is a useful reminder of the challenge facing regulators and those responsible for setting regulatory policy.

Conclusion

There are other issues I would have liked to address – the use of monitoring regimes as light handed regulation or the concept of workable versus perfect competition – but I am out of time.

Let me conclude by acknowledging that economic regulation continues to be a contentious issue. In the area of infrastructure it came into focus as governments dismantled the old statutory monopolies where regulation was by government ownership. In case there is anyone with nostalgia for the past let us remember that such regulation was far from costless and the risk of regulatory failure was no less high. This could be a topic for another talk which would include an analysis of what motivates governments, the role of taxpayers as conscripts, the role of edicts versus voluntary exchange and the efficiency comparisons of private versus public.

Economic regulation is not an exact science – this is part of the intellectual challenge that makes my role interesting. We need to continue the debate about when regulation is necessary and what makes good regulation. The community must not be overly zealous in its expectations of what regulation can achieve given the risk of regulatory failure. I have some sympathy for the views expressed in a recent letter to the Australian Financial Review by a Mark Christensen who said:

> *"Ironically, the community demands control in the hope of clinging on to what free enterprise has made available through the abolition of former controls."*

Most of all the debate needs to be based on fact not unsubstantiated assertions. In this regard I wholeheartedly agree with Gary Banks who said nearly two years ago:

> *"What is needed is a hard-headed assessment of how imperfect regulations work in correcting imperfect markets, and the gains and losses from their deployment."*

Thank you.