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"Future Energy Developments in Western Australia: Issues in Economic Regulation"

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Introduction

Thank you to the Office of Energy and the AIE for inviting me to speak at this important conference. I have been here before but not in my current capacity and I think back then I had a greater degree of freedom to express my point of view. However, I will do my best to ensure that the constraints of being a regulator don't inhibit my comments too much.

I need to start with the usual disclaimer. Although I am the Chair of the ERA, the Authority consists of three members who jointly make decisions. Therefore, the views expressed today are mine and do not necessarily represent the views of the ERA.

My first speech as Chair of the ERA was given to the AIE in June this year. Those of you who were there will remember that I referred to a favourite quotation of mine. 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."*

Most of you will be pleased to know that eight months into the job I still regard it as an appropriate warning for regulators.

However, I have another favourite quotation as well. It is an appropriate warning for those involved in public policy to remember when dealing with the commercial sector. It is by Frank Devine who writes for *The Australian* newspaper.

> "*Politics is for the sceptical consideration of wise men and the eager embrace of rent seekers"*.

I think we can safely swap regulation for politics and the last eight months have reinforced in my mind the wisdom of the comment! It is consistent with the comment attributed to Paul Keating about backing self interest – you know it is always trying!

In the time I have available today I would like to focus on two areas. First to say a little about the ERA's current activities in the energy area and second to comment on some of the current issues being debated around energy regulation, particularly arising out of the Productivity Commission's (PC's) review of the Gas Code.

The Economic Regulation Authority

The ERA commenced its activities in January with the current Authority membership commencing in March. In addition to its regulatory functions in energy, rail and water and its current inquiry into water pricing, the ERA has also been developing its own Corporate Plan and reviewing its internal structure.

The ERA's Corporate Plan will be released on our web-site in either December or January and I can also advise that we have restructured the secretariat with effect from this week. The new staff structure is shown in Appendix A and allows for the new responsibilities in electricity.

Prior to these changes the Authority was structured along industry lines consistent with the industry specific regulatory arrangements that existed prior to 1 January 2004. While an industry focus is important, as each regulated industry is well served by a clear point of contact within the Authority, it is also clear that there are certain functions that are common across the different industry groups.

For example, licensing and performance monitoring are common across all regulated industries except in rail which has a monitoring function but does not have a licensing regime. Similarly, functions involving the assessment and approval of applications such as the approval of proposed access arrangements, ring fencing arrangements and similar regulatory arrangements are common across rail, gas and electricity.

The fact that licensing and performance monitoring are common and are essentially process orientated suggests that these functions should be managed by a separate division. In effect, this will provide the opportunity for a consistent approach to licensing and performance monitoring across all regulated industry groups and will build on existing expertise within the former Water Division. The new Licensing, Monitoring and Customer Protection Division will be headed by Mr Paul Kelly.

The other main area of work for the Authority relates to the assessment and approval of applications such as for access arrangements and ring fencing. The Authority has formed the view that an industry focus continues to be appropriate but with the potential to pool resources. It is therefore proposed that the structure should include Directors: Gas Access, Electricity Access and Rail Access. As there is no third party access to water infrastructure, there is no requirement for a Director Water Access.

Given the high level of resources allocated by regulated industries to access related matters and to provide overall leadership, guidance, consistency and ensure adequate quality control, the Authority considered that industry access should be managed by an Executive Director having overall responsibility for access related matters. The Industry Access Division will be headed by Mr Robert Pullella.

Under the new structure, the management of the Authority's inquiry and reporting function will be the responsibility of a new References and Research Division headed by a Director. Arrangements to fill this position are being progressed. The References and Research Division will also have responsibility for providing a research capability to assist in the analysis of the many complex economic, financial, technical and legal issues that arise in addressing the functions of the Authority. The Division would have a specific role in providing services across all Divisions in areas such as legal advice and economic and financial analysis.

The Authority believes that this structure will be more efficient and will also provide the opportunity to make better use of the expertise available, to ensure a consistent approach and to lead to better quality control of the work of the Authority. It will enable us to focus our resources on our objective of having the ERA recognized as a leader in best practice economic regulation for the benefit of all Western Australians through promoting economically efficient outcomes at the lowest practicable regulatory cost.

I would now like to provide a brief update on current activities related to gas pipelines and also outline the ERA's future responsibilities with respect to electricity.

Gas

The Authority is currently finalizing its draft decision on Alinta Gas Network's Access Arrangement for the Mid-West and South-West Gas Distribution Systems. The existing Access Arrangement is due to finish on December 31 this year but will continue until the new arrangement is in place. We hope to have the Draft Decision out for public comment before the end of the year.

The Amended Draft Decision on the Goldfields Gas Pipeline was released on July 29. The Authority is now considering submissions received and we hope to have a Final Decision for release early in the new year.

The current Access Arrangement for the DBNGP is due to finish on June 30 next year with the requirement for a proposed new access arrangement to be submitted to the ERA by December 1 this year. The new owners of the DBNGP have submitted a request for an extension of time and the Authority is currently considering this request.

Electricity

The Authority will have several responsibilities with the commencement of the new regulatory regime for the WA electricity industry:

- access regulation of "covered networks";
- licensing of electricity industry participants;
- customer protection functions; and
- wholesale electricity market monitoring.

Access

The *Electricity Networks Access Code 2004* is expected to commence prior to the end of 2004 [most likely 1 December 2004]. Western Power's networks in the South West Interconnected System (**SWIS**) are deemed to be "covered" from the commencement of the Code. This means Western Power will be required to submit a proposed Access Arrangement within 6 months of the Code's commencement.

At the same time as the submission of a proposed Access Arrangement, Western Power will be obliged to submit proposed technical rules. The Authority will become the *technical* regulator as well as the *economic* regulator and we will soon be establishing a Technical Rules Committee to provide advice to the Authority.

In addition, the Authority is soon to commence the development of ring-fencing rules for Western Power, which remains vertically integrated, and the development of an advance determination of the weighted average cost of capital to apply to regulated networks.

The Authority intends to work closely with Western Power and stakeholders to ensure that the new access regime delivers strong benefits for all affected parties.

Licensing

The new electricity licensing regime will come into force from 1 January 2005, and the Authority will be responsible for licensing matters. Subject to certain exemptions (such as self supply), licences will be required for electricity generation, transmission, distribution or retail activities. Existing operators will hold a "deemed" licence for 12 months (until 1 January 2006). The Authority also has the power to develop codes to apply to holders of a licence or even to holders of a licence exemption. These codes may deal with matters such as metering, customer transfer or electricity supply quality and reliability issues.

Customer protection

The Authority will administer the new *Customer Service Code* from 1 January 2005. The Code binds electricity retailers and marketers to certain standards of conduct when dealing with end consumers and we will be establishing a customer consultative committee to advise on the effectiveness of the Customer Service Code.

Wholesale electricity market

The Authority's role in the new wholesale electricity market doesn't commence until the market does, in approximately July 2006.

The Authority's role will be to: approve maximum prices for the reserve capacity mechanism, maximum and minimum energy prices, and the maximum compensation to be paid in respect of generator decommitment; approve efficient costs for the operation of the Independent Market Operator (IMO) and System Management; conduct market surveillance, including working with the IMO and reporting the outcomes to the Government; and monitoring and reporting to the Government on the efficiency and effectiveness of the market.

Current Issues in Energy Regulation

There are a number of issues that have arisen, in part out of the Review of the Gas Code by the Productivity Commission, and they are relevant to the regulation of both gas pipelines and electricity networks. I want to discuss three of those issues that are themselves related – are regulators too concerned about the interests of consumers to the detriment of providers; is the cost of regulation overwhelming the benefits; and, is regulation adversely impacting on investment in infrastructure?

Before looking at each of these issues in detail I would like to make some general comments.

As I made clear in my talk to the AIE in June I am well aware of the potential for regulatory failure and the harm it can do when it does occur. The introduction of regulations can only be justified if the regulation will lead to a better result than doing nothing and accepting market failure, and it does so in a way that is better than any alternative approach. The ERA would be among the first to be concerned if current regulation was leading to an inefficient allocation of resources. Further, I acknowledge that there is arguably a greater potential loss from under-investment than from over-investment in monopoly infrastructure (within limits).

However, these are very important issues and need to be considered on a hard headed assessment of the facts. To quote the PC's Chairman, Gary Banks *"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."* Unfortunately, for reasons I will explain, in my view the PC report on the Gas Code fails this test.

In Whose Interests?

There is a very wide spread view that the challenge for regulators is to balance conflicting objectives and/or competing interests and this has led some parties to regard regulation as a battle between the interests of consumers and the interests of providers.

However, this is not a view I share and it is the area I want to comment on, particularly in the context of the current debate over the PC's review of the Gas Code. To jump ahead, I will argue that when it comes to regulating monopoly infrastructure having one over-riding objective of economic efficiency, as recommended by the PC, does not mean that the interests of either providers or consumers must be discounted. Rather, as has been recognised (in the Hilmer Report) competition policy seeks to facilitate effective competition in the interests of economic efficiency while accommodating situations where competition (or the lack of it) does not achieve economic efficiency or conflicts with other social objectives.

This focus on economic efficiency is behind the PC's recommendation for an overriding objects clause to be introduced into the Gas Code (a recommendation that I support). In Western Australia the new electricity access code will have a similar overriding objects clause. It is fair to say that the focus of regulation is to achieve a more efficient outcome than would be the case if the market was not regulated.

In this case there is only one objective, not competing objectives. This should not be a debate about whether there is regulatory bias in favour of users or consumers over providers or vice versa. It should be about whether or not regulation is contributing to the achievement of the objectives of national competition policy, in this case, greater economic efficiency than would be the case in the absence of regulation.

The current debate, particularly in energy, appears to be about whether or not regulators are biased in favour of users/consumers to the unfair detriment of providers. This is the wrong debate – there may be conflicting vested interests but from the point of view of effective competition policy, the key objective is economic efficiency.

This "wrong debate" unfortunately is present in the PC's report on the Gas Code. On page 158 the PC suggests that it may be the case that there is too much consumer interest being considered in the decisions of regulators. Now I know my economics training is somewhat dated but I thought that an important goal of economic efficiency is the long term interests of consumers. One of the reasons we have monopoly infrastructure is to provide a service to users/consumers and it is in the interests of consumers for economically efficient investment to occur, but to argue that consumers (the public) have too much influence seems a little strange coming from the PC.

The Cost of Regulation

In its Overview of the report of the *Review of the Gas Access Regime* on Roman page xxvii, the PC says:

> *"Based on the Commission's assessment (of both costs and benefits), including taking into account input from interested parties, it is reasonable to conclude that there are problems with the current regime. These mainly arise from the considerable costs the regime imposes and its real potential to distort investment and inhibit innovation."*

Before looking at the evidence on investment, I would like to comment briefly on the issue of the cost of regulation. There appears to be circularity in the argument without a lot of hard evidence.

Industry providers have argued strongly that regulation is costly and the PC appears to have accepted this view as can be seen in the previously mentioned quotation. Now providers complete the circle, by using the PC's conclusions as evidence for their own arguments. (A similar process seems to occur with respect to debates about the impact of regulation on investment.)

There were other views put to the PC although these seem to receive less coverage. For example, the Electricity Consumers Coalition of SA and the Energy Users Coalition of Victoria (which represents large industry users such as Adelaide Brighton Cement, Kimberley Clark, Holden, Ford, Pasminco, and One Steel amongst others) in a submission to the PC said in response to providers concerns about regulatory imposts:

> *"This clearly overlooks the fact that most of the obligatory imposts are carried by consumers, and not by the pipeline industry. What is consistently avoided by the pipeline industry is that the cost of providing the regulatory oversight is borne by governments (taxpayers who are also consumers) or directly by consumers via a levy. Similarly the costs incurred by pipeline companies in carrying out their regulatory functions are accepted by the regulators to be legitimate business expenses and so are recoverable under the revenue determination. Consumers carry their own costs of participating in regulatory reviews………As consumers accrue the benefit of increased economic growth and clearly if they are of the view that they benefit from the Gas Code as currently written, then surely it is not up to the pipeline industry to decide how the consumers might wish to conduct their affairs."*

The same group in a response to the PC's Draft Report also made a submission about the estimated costs of regulation and I quote:

> *"1 cent per gigajoule is worth it for the economy to be protected against monopoly pricing for a key industrial input."*

Perhaps the one conclusion a regulator can draw from this is that we need to be careful about the use of loose language – there does appear to be more than one industry view!

Effect of Regulation on Infrastructure Investment

The main theme underlying the PC's report is that it maybe the case that regulation is "chilling" what would otherwise be efficient investment. As I said earlier if this was the case then it would be a very serious issue. How could this "chilling" occur and what, if any, is the evidence?

The PC (in chapter 4) makes a theoretical case about why such "chilling" could occur. It acknowledges that any evidence is anecdotal and establishing the counterfactual is difficult, and so tends to assume that because a theoretical case can be made, that therefore it is probably happening, at least in some areas. Of course, it would be just as easy to make the theoretical case that it doesn't occur and that in addition regulation facilitates investment in upstream and downstream markets – this is one of the main objectives of national competition policy!

"Chilling" of 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. The PC makes a case that there is uncertainty, but I think they overstate their case on the basis of what are relatively minor differences between regulators and by a focus on the determination of ICB's for existing infrastructure, which is of lesser concern for new investment.

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 DBNGP case but it is not a conclusion that, in my view, can be reached by an objective assessment of the case. I don't have time to deal with this case today but for those interested I addressed this issue in my speech to the AIE in June and the speech is on the ERA website.

The other way in which efficient investment could be deterred is if the regulators applied non-commercial rates of return. The PC report is disappointing in its treatment of this issue. Rather than simply rely on the fact that a theoretical case can be made that investment "chilling" could occur, it is not unreasonable to expect that the PC would have undertaken an objective assessment of whether or not regulators have allowed commercial rates of return. The PC report discusses submissions received and says that "……regulatory rates of return are set on the basis of many assumptions. Such assumptions are used because regulation is applied in a world of uncertainty. This uncertainty cannot be removed by requesting more information from service providers, or by hiring consultants to undertake studies." (pp. 301-2) And yet recommendation 7.11 (page 302) recommends "A study should be undertaken by a group of recognized experts ……." One could ask why this was not a role for the PC – where is their objective assessment of whether or not rates of return applied by regulators are consistent or inconsistent with market expectations?

Are Rates of Return Used by Regulators Too Low?

There is evidence on this issue presented to the PC, for example the Allen Consulting Group report submitted by the ACCC or the response by Network Economics Consulting Group. On my reading the research that has been done would suggest that rates of return set by regulators have not been low in commercial terms and the responses to those studies tend to focus on methodological issues in the initial studies rather than offer contradictory evidence.

There is also some selective quoting and/or reading of the literature, particularly as it relates to the work of the US finance academics Eugene Fama and Kenneth French contained in the PC Report and in submissions to the PC. There is not time to deal with this in detail, but my reading of the literature suggests that Fama and French's three or five factor model can provide a reliable guide to rates of return expected by the market. Further, their work suggests that for utility stocks in the US the market risk premium is between 3-5 per cent over the risk free rate – well below the rates used by Australian regulators. It would have been useful for the PC to do their own analysis of this literature rather than simply report on the debates between those making submissions (each with their own potential biases).

I have looked for evidence that regulators might be setting non-commercial rates of return. The problem is the more I look the more the evidence tends to support a view that regulators have been realistic, if not generous. This includes both academic studies and the work of independent financial consultants and advisors.

There is also the reasonableness test. If regulated assets are being set rates of return that are too low, why are there still buyers for the assets, for example Alinta's recent purchase of the Duke assets or the Alinta/Alcoa/Duet purchase of the DBNGP or the purchase of the majority of the Goldfields Gas Pipeline by the Australian Pipeline Trust? Incidentally, this later purchase was announced the day the ERA released its Amended Draft Decision for the GGP. Or if rates are too low, why do regulated assets often trade at a premium to their regulated value and why do banks come to see the ERA saying they are interested in purchasing regulated assets. Finally I am aware of Australian super funds who regard regulated assets as a form of debt investment with lower hurdle rates than equity investments. This is consistent with the views expressed by Brett Lazarides, the head of infrastructure at Perpetual Investments who said in the Financial Review (September 22, 2004) in response to a question regarding the appeal of infrastructure assets *"Its effectively a recession-proof asset class……It can provide returns in excess of those available from the listed markets with lower levels of risk"* or the report in Energy Review on Nov 2 which said *"Analysts say there is a strong demand for infrastructure stocks because of their predictable cash flow and high returns"*.

I repeat, if regulation is stifling efficient investment that would not be in the interests of anyone, but I have yet to see the evidence. The fact that it is asserted, or the fact that a theoretical case can be made that it could occur, is not a good enough reason to change the Gas Access Regime which the PC itself says *"has delivered benefits through determining the terms of third party access to pipelines and facilitating competition in upstream and downstream markets"*. (Finding 4.2)

Conclusion

Energy infrastructure is very important to the future economic development of Western Australia and the ERA is very mindful of this fact. The ERA will continue to focus its efforts on being a leader in best practice economic regulation for the benefit of all Western Australians by promoting economically efficient outcomes at the lowest practicable regulatory cost. We will do this through efficient, effective and independent regulation, by providing independent advice to government and by advancing the debate in economic regulation. Hopefully, I have contributed to this latter objective in my presentation today.

Thank you for listening.

Appendix A : ERA Revised Corporate Structure

Secretariat