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UTILITY REGULATORS FORUM SUBMISSION TO THE MINISTERIAL COUNCIL ON ENERGY REVIEW OF THE NATIONAL GAS PIPELINES ACCESS REGIME CONSULTATION PAPER

The Utility Regulators Forum[1] welcomes the opportunity to make a submission to the Ministerial Council on Energy (MCE) Review of the National Gas Pipelines Access Regime consultation process in response to the consultation paper prepared by the MCE Standing Committee of Officials. The Utility Regulators Forum acknowledges that this consultation process represents a key element of the MCE's coordinating role in the development and implementation of the Council of Australian Governments' regulatory reforms in response to the Productivity Commission Review of the Gas Access Regime.

The Utility Regulators Forum supports the MCE's efforts to improve the efficiency and effectiveness of the regulatory regime and the consideration of amendments aimed at providing access seekers and investors with greater confidence and certainty regarding the regulatory framework. A number of the Utility Regulators Forum's constituent regulatory agencies made a significant contribution to the Productivity Commission review process, including formal submissions in response to the issues paper and draft report, and participation in the Commission's public hearings.

This submission builds on the themes explored in the earlier Utility Regulators Forum paper to the MCE[2] and confirms regulators' willingness to contribute to improving the efficiency and effectiveness of the regime through contributing views from an operational perspective given their practical experience in administering and enforcing the various provisions of the current

[1] The Utility Regulators Forum consists of Commonwealth, State and Territory regulatory agencies responsible for administering the regulatory regimes in utilities industries. Membership of the Utility Regulators Forum consists of: ACT Independent Competition and Regulatory Commission (ICRC); Australian Competition and Consumer Commission (ACCC); Australian Energy Regulator (AER); Commerce Commission New Zealand; Economic Regulation Authority, Western Australia (ERA); Essential Services Commission of South Australia (ESCOSA); Essential Services Commission, Victoria (ESC); National Competition Council (NCC); NSW Independent Pricing and Regulatory Tribunal (IPART); Office of the Tasmanian Electricity Regulator (OTTER); Queensland Competition Authority (QCA); Tasmanian Government Prices Oversight Commission (GPOC); and Utilities Commission Northern Territory.

[2] Utility Regulators Forum 2005, *Paper to the Ministerial Council on Energy by the Utility Regulators Forum*, April (available at: http://www.accc.gov.au/content/index.phtml/itemId/603880/fromItemId/3894).

regulatory regime. The submission is structured in a similar format to the consultation paper prepared by the MCE Standing Committee of Officials.

High-level guidance – insertion of an objects clause

In the earlier Utility Regulators Forum paper to MCE regulators indicated support for the inclusion of an overarching objects clause in the *National Third Party Access Code for Natural Gas Pipeline Systems* (the Gas Code), which would bring greater certainty and clarity to the legislation by providing clear guidance to regulators for resolving any tension in subordinate objectives when exercising regulatory discretion. The Utility Regulators Forum supports the primacy that the objects clause places on economic efficiency, consistent with the overarching objective of regulatory intervention being to promote — insofar as it is possible — the crucial resource allocation efficiency and overall economic welfare that would otherwise come from a competitive market environment.

The Utility Regulators Forum supports reference within the objects clause to promoting effective upstream and downstream markets, given this is fundamental to the coverage test. And whilst the Utility Regulators Forum endorses the MCE view that a key element of the regime is to promote "*the long term interests of consumers of natural gas with respect to price, quality, reliability, safety and security of supply*", the focus needs to remain on developing an objects clause which is concise and clearly articulates the objective to be achieved — economic efficiency.

The Utility Regulators Forum has however expressed concerns regarding the Productivity Commission's recommended deletion of the regime's subordinate objectives contained in section 2.24 of the Gas Code. To the extent the remaining two subordinate objectives (namely consideration of binding contractual obligations and technical requirements for safe and reliable operation) could complicate and potentially skew the balance in applying the overarching objects clause, the Utility Regulators Forum supports the retention of the subordinate objectives relating to regulators being required to have regard to the interests of users and the service provider.

It is noted that the consultation paper proposes consideration of this issue in the context of developing the common legal framework for the gas and electricity access regimes. Nevertheless, the Utility Regulators Forum is of the view that retention of subordinate objectives will assist the regulatory process, by providing guidance to the regulator and interested parties on matters to be taken into account and preserving balance in the exercise of any discretion involved. In terms of the development of a common set of provisions in the electricity and gas law, the Utility Regulators Forum is of the view that the Australian Energy Market Commission (AEMC) is best placed to conduct this further work.

Form of regulation

Covered pipelines by definition possess a substantial degree of market power, whether this is in the form of the ability to extract monopoly rents to the detriment of all consumers or engaging in preferential treatment of a vertically integrated arm of the infrastructure service provider's business adversely affecting competition in an upstream or downstream market. Once covered, the default position must be that any pipeline should be subject to an effective regulatory regime in order to prevent the potential misuse of monopoly power.

As the Productivity Commission recognised in reformulating its recommendations following submissions to the Draft Report, price monitoring in itself would not be sufficient in order to meet the requirements for certification of the regulatory regime as effective. At a minimum the regime would require an effective dispute resolution mechanism (for example, Part IIIA of the *Trade Practices Act 1974* specifies a negotiate/arbitrate model).

The Utility Regulators Forum notes there are a number of other critical design issues regarding the proposed light-handed monitoring options that require careful attention. It will be necessary to clarify the obligations that will be placed on service providers, address asymmetric information issues, and clearly define the threshold between (and determine a process for switching between) the two forms of regulation. A clear understanding of information requirements will be needed to support such a monitoring regime, so that regulators can provide the level of assurance required for stakeholders to be confident that the regime is working as planned. It is also essential that the threat of future regulatory action is clear and credible if more light-handed regulatory approaches are to be effective in preventing the misuse of substantial market power.[3]

The Utility Regulators Forum is also concerned by the suggestion in the consultation paper that the monitoring regime reflect the existing Australian airports regime on the basis of the infrastructure industry having "*endorsed the airports regime as a template for [monitoring of] other industries*".[4] Accepting the views of infrastructure owners as constituting an 'industry' position potentially ignores the legitimate concerns of infrastructure users, and significant concerns have been raised regarding the design of the airports monitoring regime vis-à-vis recent increases in prices.[5]

Certainty for mature networks

The Utility Regulators Forum concurs with the MCE view that the broader energy market reforms should assist in improving the degree of certainty for investors in regulated businesses and improve the quality of economic regulation. However, the Utility Regulators Forum is concerned that the recommended changes aimed at increasing certainty for mature networks may in fact work counter to this, and introduce greater uncertainty — at least in the short to medium term — and potentially render a significant amount of regulatory and review precedent irrelevant.

It is generally accepted that the existing regime is settling, particularly with an increasing body of regulatory precedent emerging guided by Supreme Court rulings and judgements by review bodies. Accompanying this settling of the regulatory system is a greater level of confidence, both for service providers being able to predictably rely on the outworking of the regime and also owners of investment capital being willing to participate in significant

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[3] The Utility Regulators Forum paper to MCE noted that, for example, due to successive New Zealand governments having staked substantial political capital on the virtues of light-handed regulation, this meant that the threat of regulatory intervention was never particularly credible. Incumbents ultimately discounted the likelihood of regulatory intervention, and the regulatory arrangements constituted very little, if any, constraint on the behaviour of utility businesses – see discussion in National Economic Research Associates (NERA) 2004, *Alternative Approaches to 'Light-Handed' Regulation*, report for the Essential Services Commission Victoria, Sydney, 5 March (page 27) (available at http://www.esc.vic.gov.au/index768.html).

[4] MCE Standing Committee of Officials consultation paper (page 12).

[5] For example, see speech made by Michael Keating (Chairman, NSW Independent Pricing and Regulatory Tribunal), *Economic Regulation and the Provision of Infrastructure*, to the NSW Economic Society, Sydney, 17 August 2005 and associated article in the Australian Financial Review titled "*What Crisis? Asks pricing regulator*", 18 August 2005 (page 7). Noted also is the formal response from Max Moore-Wilton (SACL Chairman) in the Australian Financial Review, *Letters to the Editor*, 23 August 2005 (page 58).

infrastructure investment. There is a large degree of comfort with the certainty the regulatory regime provides — industry appears to be satisfied with the certainty of returns the regime is providing and there appears to be significant interest amongst fund managers to establish infrastructure-based investment vehicles given the certainty of regulated returns.[6]

The danger the Utility Regulators Forum sees in embarking on changes at this stage is that such has the potential to introduce significant uncertainty; the very point the recommendations seek to reduce. The value of the regime's regulatory precedent should not be underestimated, and considerable costs may be incurred in establishing an equivalent level of jurisprudence in the event that significant amendments to the regime are implemented.

The Utility Regulators Forum is also of the view that the recommended amendments should be based on evidence of what is actually happening, not what theoretically might be happening. Only those amendments which are absolutely necessary should be contemplated — and only then when it is certain that those amendments will actually improve the system — as experience in the implementation of changes demonstrates this inevitably increases uncertainty, for service providers, users and the economy more generally.

Promoting greenfields projects

The Utility Regulators Forum maintains significant concerns with the Productivity Commission's conclusion that the design and application of the regulatory regime has the potential to deter investment and citing this as the justification for amendment to the regulatory regime without appropriate scrutiny or rigour being applied in assessing whether the evidence supports such amendment.

If economic regulation is stifling efficient investment, that would be a significant problem and definitely not in the interests of promoting long term national prosperity. However, the available evidence does not support this conclusion. Observations have found that rates of return appear to have been adequate, if not more than adequate relative to other comparable businesses, and significant investment in essential infrastructure has occurred. For example, the length of natural gas transmission pipelines has doubled in the past seven years[7] and capital market data indicates that utility assets have significantly outperformed the general market in recent years.[8]

Nevertheless, the Utility Regulators Forum recognises that some parties may take comfort from the certainty provided by a binding coverage ruling for proposed greenfields investments. The Productivity Commission's recommendation to permit pipeline developers to seek an upfront test and obtain a binding ruling for 15 years may achieve this outcome

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[6] See article by James Hall (*Australian Financial Review*, 30/8/2005, page 21) which discusses speculation regarding the establishment of utilities-based infrastructure funds and significant demand in current floats (e.g. Alinta Infrastructure Holdings pipeline and power station trust).

[7] See infrastructure investment levels referred to Willett, E (2005), *Regulating national infrastructure to guarantee long term investment*, Presentation to the AFR 4th National Infrastructure Summit, Sydney, 25 August, quoting Australian Pipeline Industry Association published figures.

[8] Over the ten years to June 30 2005, the Australian UBS Utilities Index (comprising almost totally of energy assets) has generated a compound annual return of 22.9% compared to the S&P ASX 200 Accumulation Index return of 12.2%. Over the 2004-05 financial year, the difference is more pronounced: 39.8% compared to 26.4% (see Edwell, S (2005), *The AER and the new regulatory environment*, Presentation to the Inaugural Australian Energy Retail Congress (IBC Conferences), Sydney, 5 September).

regarding certainty. However, the Utility Regulators Forum does not support the proposal in the consultation paper for a blanket exemption for all greenfields pipelines. This may result in exemptions being granted to pipelines which ultimately could exert significant market power, and there is some question whether a regime offering a blanket exemption could satisfy the effectiveness requirements under Part IIIA of the *Trade Practices Act 1974*.

The Utility Regulators Forum is of the view that it would be appropriate to consider each pipeline proposal on a case-by-case basis, which is consistent with the Productivity Commission recommendation. In addition, a number of issues with the proposal will need to be further developed. For example, the definition of what constitutes a greenfields development will need to be clearly articulated, including the tests to be used to determine whether a proposed development satisfies the greenfields criteria.

Administration of the coverage test

The Utility Regulators Forum considers it appropriate for the National Competition Council (NCC) to retain responsibility for administering the coverage test. The Utility Regulators Forum notes that the AEMC was established for rule making and market development, and hence could ultimately be required to review coverage rules. It would be inappropriate for the body responsible for reviewing coverage rules to also be responsible for administering the application of those rules. The Utility Regulators Forum also notes that, in the event the AEMC was charged with responsibility for administering coverage under the gas regime (and presumably the electricity regime in order to achieve consistency), divergence may result with other industry regimes under National Access Regime (where responsibility would remain with the NCC, as the AEMC has no jurisdiction with respect to ports, rail, airports, etc.).

Specific guidance on pricing matters

Significant debate has surrounded the detail regarding specific guidance to decision makers on pricing matters. And whilst amendments which achieve greater clarity in the application of the regime are supported, there is a real need to ensure any amendments (such as the proposed pricing principles) are warranted and correct before being implemented. Furthermore, regulators have previously expressed concerns regarding the content of the pricing principles proposed by the Productivity Commission. For example:

- the lack of clarity associated with the term "at least" (in reference to regulated access prices being set in order to generate revenue that is *at least* sufficient to meet efficient costs) and how imposing a floor without a ceiling does not provide greater clarity or predictability in a propose-respond model, instead potentially increasing ambiguity, lessening certainty and potentially providing greater scope for aggrieved parties to pursue avenues of review;[9]

- reference to "regulatory risk" (i.e. that regulatory decisions should provide for revenue commensurate with *regulatory risks* involved in service provision). It is difficult to argue that there is evidence of significant regulatory risk given there has been significant consistency in regulatory decision making and adequacy in regulatory rates of returns. It is also questionable whether, in capital markets offering widespread opportunities for

[9] See Economic Regulation Authority submission to the Senate Economics Legislation Committee Inquiry into the provisions of the Trade Practices Amendment (National Access Regime) Bill 2005 (page 3).

portfolio diversification, such risk would have any relevance. These concerns are heightened given the latest draft of the pricing principles which is understood to have replaced "commensurate with" with words requiring a return for regulatory risk — implying a requirement for an explicit allowance despite difficulties in measuring and ultimately being inconsistent with any actual risk;[10] and

- that the existing subordinate objectives of the regime (in section 2.24 of the Gas Code, if retained) provide sufficiently broad guidance and discretion to adequately deal with the complex pricing and non-pricing issues.[11]

Nevertheless, further consideration of pricing principles is supported (provided they constitute correct and well-defined guidance to regulators), as well as aligning such principles across the electricity and gas industries. However, specific guidance in the form of pricing principles can overstate the importance of pricing matters vis-à-vis other, equally important terms and conditions of access (foreshadowed in the objects clause section above) and careful consideration in the framing of pricing principles will therefore be important.

Improving regulatory processes

The earlier Utility Regulators Forum paper to MCE outlined regulators' concerns regarding the recommendation to remove a regulator's ability to extend an access arrangement review period deadline more than once. Placing inflexible limitations on timing for some steps of the process could undermine the effectiveness of the assessment process. Information asymmetries exist, as regulators are typically very dependent on other parties for the supply of necessary information and the design of the regime can encourage service providers to withhold relevant information. Regulators need to have sufficient time to be able to objectively assess compliance with the regulatory regime's requirements (including sufficient and transparent public consultation). Further, revisions to the current target timeframe provisions will introduce a degree of inconsistency between the regulatory regime and that provided for in the (soon to become effective) revised National Access Regime.

Improved mechanisms to achieve realistic timeframes for conducting reviews could be contemplated. However, it must be remembered that a compromised or rushed regulatory process that does not facilitate a proper consideration of the issues or is frustrated by delaying tactics can leave consumers and/or upstream and downstream markets exposed to the exercise of market power in pricing and service provision. The focus needs to remain on the regime delivering robust outcomes that instil confidence in current and prospective market participants. Accordingly, the Utility Regulators Forum is of the view that any time limitation imposed on regulators should also allow for suspension of a deadline in the event of insufficient information provision[12] and accompanied by sufficient information gathering powers to avoid any incentive for delay.

[10] See Independent Competition and Regulatory Commission submission to the Senate Economics Legislation Committee Inquiry into the provisions of the Trade Practices Amendment (National Access Regime) Bill 2005 (page 3).

[11] See Australian Competition and Consumer Commission *Response to the Productivity Commission Position Paper: Review of the National Access Regime* (page 27).

[12] See, for example, suspension of deadline provisions contained within of the *Electricity Networks Access Code (WA) 2004* (section 4.68).

High-level regulatory policy issues

The consultation paper acknowledges a number of high-level regulatory policy issues (namely, scope of regulator discretion, information gathering powers and appeals processes). It indicates these issues will be examined as part of a separate consultation process and discussion paper (in the case of appeals provisions)[13] or considered in the context of the development of a common set of provisions in the electricity and gas law governing access in these industries.

Nevertheless, the Utility Regulators Forum reiterates the points made in its earlier paper to MCE regarding these pertinent issues. In particular:

- concern was expressed regarding the need for explicit limitations on the definition and breadth of the "plausible range", as the very wide range of values that can be derived from historical information using statistical analysis may make it difficult for a regulator to reject a value that is clearly inappropriate. As the consultation paper validly notes, such a criterion for decision-making may imply more disputes in future and may counteract the objective of improving the degree of certainty and predictability of regulatory decisions. It may also potentially compromise the original intent of the regulatory regime and hence inhibit the realisation of economically efficient outcomes. Greater predictability is likely to come from narrowing (rather than exacerbating) the "plausible range" definition. And retaining the current arrangements to the extent possible will preserve the relevance of precedence established through merit and judicial review processes, hence further bolstering predictability.

  The Australian Energy Regulator (AER) in its recent Compendium of Electricity Transmission Regulatory Guidelines[14] proposed to continue exercising judgement in its application of the empirical evidence from the market to determine appropriate benchmark parameter values when assessing proposed regulatory prices, whilst recognising the need to refine parameter estimates and methodology in light of new available data. This is consistent with the view in the consultation paper regarding empowering the AER to make the best decision it can within the boundaries set by the rules governing the decision-making process, hence providing the necessary certainty of outcomes whilst preserving the regulatory regime's objectives in arriving at an economically efficient outcome;

- the earlier Utility Regulators Forum paper to MCE noted concerns with the recommendations which proposed limitations on information gathering powers. Though regulators are conscious of the need to limit data collection to that which is clearly relevant to the task, limiting information collection which is necessary for effective, informed regulation undermines the public policy objectives of the regime. Even the most light-handed model of regulation requires reliable, credible and consistent information, as regulators operating on insufficient information can leave consumers and/or upstream and downstream markets exposed to the exercise of market power in pricing and service provision.

[13] Ministerial Council on Energy, *Energy Market Reform Bulletin No. 47* (1 September 2005), indicates a paper by the Merits Review Working Group under the MCE Standing Committee of Officials is expected to be released shortly.

[14] Australian Energy Regulator (AER) 2005, *Compendium of Electricity Transmission Regulatory Guidelines*, August.

Insufficient information gathering powers exposes the regime to information asymmetry gaming (a point explored in the previous section). The provision of robust, consistent information is also critical in providing for the development of more effective regulation in future — such as productivity-based approaches to price cap incentive regulation using Total Factor Productivity indexes.[15] Accordingly, the Utility Regulators Forum concurs with the preliminary MCE view in the consultation paper regarding the need for regulators to have robust information gathering powers to perform their respective functions; and

- regulators expressed concern regarding the efficiency and appropriateness of merit review bodies being tasked with replicating the entire pricing decisions made by regulatory bodies, as views on these intricate details are developed over longer periods and with the support of expert analysis and extensive consultation. It is also questionable the extent to which re-arbitration can add to greater certainty of regulatory outcomes. The Utility Regulators Forum therefore looks forward to the separate MCE discussion paper on this issue.

Similar to the Utility Regulators Forum's view regarding the AEMC being best placed to conduct further work on the development of a common set of provisions in the electricity and gas law, the Utility Regulators Forum also suggests the AEMC would be best placed to continue further work on the above issues of regulatory discretion and information gathering powers.

Other regulatory matters
The earlier Utility Regulators Forum paper to MCE highlighted some of the deficiencies in the regime's ring-fencing provisions and regulatory reporting guidelines. Regulators are concerned by the ability (and inherent incentive) under the regime for service providers to circumvent and undermine the regime's efficient cost-based approach to setting prices as a result of inappropriate and insufficient ring-fencing provisions and requirements for the keeping of regulatory accounts. It is considered that the Productivity Commission recommendations go some way to addressing the issue of maintaining information.

However, the Productivity Commission recommendations appear to lack clarity and problems remain. These include:

- the scope for issuing regulatory accounting guidelines to identify and define the information required, noting that they are only referenced under the ring-fencing provisions of the Gas Code;

- the potential use of asset management contracts to circumvent the objectives of the regime; and

- the status and appropriateness of Attachment A to the Gas Code, which has never been reviewed in the light of regulatory experience and specifies data which is not relevant while omitting other information relevant to effective regulation.

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[15] See for example, research commissioned by Essential Services Commission (Victoria) regarding the productivity trends achieved by the Victorian electricity distributors and assessing the scope for using Total Factor Productivity indexes to determine the X factor under a CPI-X approach to price cap incentive regulation (available at http://www.esc.vic.gov.au/electricity994.html).

These issues are also particularly relevant with respect to the proposed monitoring regime, as vertical integration can lessen the potential effectiveness of price monitoring models when anticompetitive leveraging is possible and the effectiveness is further diluted if the regulator faces significant information asymmetries.

The Utility Regulators Forum concurs with the view in the consultation paper that the above matters be considered in the context of the further work on development of a common set of provisions in the electricity and gas law.

Concluding comment and invitation for further discussion
The Utility Regulators Forum supports the MCE efforts to strengthen competition, encourage investment and achieve greater economic efficiency in the energy market by improving the quality of energy regulation. The views expressed in this submission and the previous Utility Regulators Forum paper to MCE provide detailed discussion from a practical perspective and are deserving of consideration by the MCE in the context of its deliberations regarding the merits of any changes to the current regulatory framework. To further assist the MCE, the Utility Regulators Forum would be delighted to avail itself to discuss the above issues in greater detail and fully participate in any future public hearing or consultation process.

For consideration.

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On behalf of the Utility Regulators Forum