

Australian Pipeline Industry Paper In Response to the Paper to the Ministerial Council on Energy by the Utility Regulators Forum

Recently the Utility Regulators Forum (URF) submitted a paper to the MCE commenting on the Productivity Commission's (PC) Review of the Gas Access Regime. The Australian Pipeline Industry Association (APIA) wishes to respond to several issues arising from this paper.

This APIA submission does not address the URF paper issue by issue but covers a number of areas:

1. role of regulators under the MCE process;
2. objectives of regulation under the Gas Code;
3. importance of merit appeals;
4. rates of return and plausible ranges; and the
5. light-handed approach to regulation.

APIA is willing to provide further information to clarify any of the points made in this paper.

1 Role of Regulators in Policy Processes

Industry participants - producers, pipeliners, networks, retailers and end users - all have invested capital and all have an interest in seeking that policy-makers address their concerns.

Under the gas access regime the regulator's principal role is to make and execute decisions within a given regulatory framework, not to actively lobby policy-makers to amend legislative and policy frameworks. It is inappropriate for independent decision-making bodies to actively argue certain positions, including whether or not the regulators' decisions should be subject to independent review.

APIA also submits that, by arguing against implementation of the improvements to the gas access regime recommended by the Productivity Commission, regulators may also undermine confidence in the regime.

2 Objectives of Regulation

APIA agrees with the URF that lack of clarity about the fundamental objective of the gas access legislation is an issue (URF p1). The implementation of the PC Report (Recommendation 5.1) would overcome this, bringing greater consistency and certainty to gas regulation. As the MCE will be aware the PC proposes the objective of the gas access regime as:

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

As is proper, the objects clause proposed in the PC Report does not limit the means of achieving the objective. The URF also supports such a clause, however, the URF (p2) supports an objectives clause being expressed in terms of:

focussing on economic efficiency, consistent with the overarching objective of regulatory intervention being to promote - insofar as possible - the crucial

resource allocation efficiency and overall economic welfare that would otherwise come from a competitive market environment.

In contrast to the PC approach, the URF's approach indicates that regulators would interpret an overarching objectives clause as requiring the use of regulatory intervention based on a competitive market model as the means to achieve economic efficiency. This is inconsistent with the PC's (p260) strong criticisms of an approach to regulation that tries to set reference tariffs according to a theoretically competitive market model:

"In addition, the Commission does not consider that s.8.1 (b) 'replicating the outcome of a competitive market' is an appropriate objective for setting reference tariffs. This objective suggests that it is possible to determine the tariff that would be the outcome of a competitive market and then replicate it. As noted in chapter 4, although regulators can aim to estimate a competitive market's efficient prices, it is unlikely that the estimated prices will actually reflect efficient prices. This is partly a result of the high probability of regulatory error, but is also a result of the fact that competitive markets are dynamic in nature (chapter 4). If the competitive market outcome cannot be estimated then it follows it cannot be replicated.

"Further, as noted above there are a wide range of interpretations of a competitive market — such as perfect and workable competition — each delivering a different outcome."

The PC also found (Finding 7.2) that:

"Replicating the outcome of a competitive market (s.8.1(b) of the Gas Code) is an unachievable objective for setting reference tariffs. Seeking to apply the concept of workable competition does not provide a practical approach to this problem."

The PC based its recommendations on the promotion of economic efficiency instead. Under such an approach the PC argued that promoting competition would not erode the primacy of the efficiency objective as by promoting economic efficiency it flows that competition in related markets is improved (ie as a flow on effect). As this would apply to all types of competitive markets the problem of which competitive market is reduced.

The URF's interpretation of the objective appears to have misunderstood the consistent economic framework behind the PC's approach. APIA believes the MCE should adopt the consistent framework recommended by the PC for gas regulation, and should not regard regulation as being an objective in itself.

3 Appeals Processes

Any regime under which a decision-maker is given considerable discretion requires an appeals system to ensure that decisions are subject to proper scrutiny, thus ensuring accountability of decision-makers and transparency in the process. This is reflected in the fact that significant government and administrative decisions in Australia are typically subject to rights of review. Given the extent of powers and discretion granted to the regulators under the Gas Code, and that the regulators' decisions substantially and directly affect the profitability or viability of a business, the existing review rights must be maintained, if not expanded.

In the final report of the PC the issue of merit appeals was widely analysed with the PC (p498) viewing the issue as extremely important for service providers and users of the assets:

"There is a need for a merits review under the Gas Access Regime. In the Commission's view, appropriate protection for property rights and natural justice are key considerations. While the appeal process might take considerable time and expend considerable resources, the regulatory bodies and Ministers have powers to make decisions that have an impact on fundamental rights of service providers. The prospect of exposure to imperfect regulatory instruments means there is a strong case for a merits review."

The PC recommended strengthening the role of merit review in the National Gas Code.

The URF (p7) argues that merit reviews should focus on "remediating clearly inappropriate decisions". This argument suggests that review bodies should be concerned only with matters of principle and not examine detailed pricing decisions by regulators. However, this is inconsistent with the breadth of the powers and discretion granted to the regulators under the Gas Code. This proposed reduction in review rights is also questionable as four of the five merits reviews have demonstrated that errors potentially having a substantial impact on the service provider's permitted revenue had been made.

Arguments against preservation of the existing review rights under the gas access regime also fail to recognise two fundamental considerations – firstly, the Hilmer Report recognised that the introduction of third-party access was a significant interference with property rights and emphasised the need to ensure proper recognition of this: the right of review is an important part of such recognition. Additionally, the Competition Principles Agreement mandates that there be appeal rights against the decision of the arbiter, clearly recognising the need to ensure that there is an appropriate mechanism to correct errors by the decision-maker, for the protection both of users and service providers.

The current review system under the Code is working. Review bodies are focussed, they establish where the parties are in basic agreement and only deal with matters in dispute. There have been only five Code appeals in relation to transmission pipelines and none in relation to distribution pipelines.

There has been considerable use of the term "cherry-picking" in connection with reviews under the Gas Code. The term implies that there is something wrong or unacceptable with service providers or users appealing only against outcomes which they consider unfavourable. At a fundamental level, it seems reasonable that a party would only appeal against an adverse outcome.

APIA submits that there has been no case made for removal or watering down of review rights under the Code. In fact, the evidence of the reviews to date is that errors can be made under the Code, and that service providers and users typically do not seek reviews except where the error has a significant impact on the service provider's financial position. Given this history, any limitation or removal of review rights would undermine confidence in infrastructure investment as well as result in failure to comply with the Competition Principles Agreement.

APIA notes that the PC did not deal with the issues of "cherry picking" and confirmed the basis of the appeal arrangements under the Gas Code that the service provider can determine which issue is appealed on the basis of the overriding importance of the service provider's property rights.

4 Rates of Return and the Plausible Range

APIA supports the "plausible" range approach put forward by the PC (p296) which it argued was necessary because:

"Implementing the WACC/CAPM approach is not a precise science, given the numerous debatable assumptions involved. There is even disagreement on the precise formulas to use, due to different views on how issues such as tax should be treated. Hence, a range of plausible values can be generated for the regulatory rate of return using the WACC/CAPM approach. This in turn implies that meeting the Gas Code's requirements does not automatically lead to a single indisputable number for a reference tariff".

The URF (p5) argues that the PC's "plausible range" approach to rate of return "undermines the role of the regulator and will seriously compromise the regulatory regime". APIA submits that it is difficult to conclude how an outcome within a reasonable range would compromise a regulatory regime, unless the regime is flawed.

5 Light-handed regulation and monitoring

APIA supports the development of lighter-handed regulatory approaches, including the monitoring option supported by the PC. In particular APIA supports the PC's emphasis that a monitoring approach must not develop into intrusive regulation.

APIA agrees with the PC's view (pLV) that a monitoring regime would consist of a third party access policy, anti-competitive conduct provisions, ring-fencing provisions and public disclosure of specified information.

APIA is aware that the Energy Networks Association (ENA) has also responded to the URF paper. APIA generally supports the ENA's position, although we note ENA assumes that the "monitoring" option supported by the PC is "price monitoring", whereas the PC Report canvasses a range of monitoring options including ring fencing provisions and, possibly, a voluntary code of conduct.

Conclusion

APIA supports the implementation of the PC's report in its entirety. The PC Report is a consistent package and to pick and choose different parts is to adversely limit the impact, and will ensure that the regulatory model will not maximise long-term consumer welfare.

APIA is willing to provide further information to clarify any of the points made in this paper.