



The Australian Gas Association

Submission to the Queensland Competition Authority

**Review of the Form of Regulation of
Electricity Distribution**

Response to Discussion Paper

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Overview

In October 2002 the Queensland Competition Authority (QCA) released the paper *Review of the Form of Regulation of Electricity Distribution* (discussion paper). The discussion paper examines issues relating to the current cost-based form of access pricing applied under the National Electricity Code in the context of the price determination for electricity distribution networks scheduled to occur in 2005.

The discussion paper was released at the same time as several important developments in access regulation with broad significance for public policy. The discussion paper addresses in detail only a relatively narrow range of issues associated with technical aspects of the form of regulation applicable under the National Electricity Code.

The discussion paper was completed in parallel to four significant policy developments. These developments are the :

- release of the final report of the Productivity Commission *Review of the National Access Regime*
- announcement of an interim Federal Government response proposing amendments to the national access regime supporting the broad thrust of the Productivity Commission's findings and recommendations
- Western Australian Supreme Court issuing its judgement in *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Ano*
- release of the draft report of the Council of Australian Governments Energy Market Review

Some aspects of the discussion paper appear to be inconsistent with the policy directions and implications of each of these developments. The AGA urges the QCA to reconsider the issues associated with determining the form of regulation under the National Electricity Code in the light of these developments, with a view to taking a wider approach which emphasises the objective of workable competition, and the significant risks associated with under-investment in critical energy distribution infrastructure.

Background

This submission responds to the Queensland Competition Authority discussion paper *Review of the Form of Regulation of Electricity Distribution* released in October 2002.

The AGA represents the downstream sector of Australia's natural gas industry, including owners and operators of regulated gas distribution networks, gas pipelines and gas retailers. This submission represents the views of core AGA members owning regulated gas distribution networks.

Many of AGA's core members own combined gas and electricity distribution businesses, making developments in access regulation covering energy distribution networks a critical area of concern. In addition, across States and Territories, jurisdictional regulators typically make determinations covering both electricity and gas distribution networks. Given this, the present review provides an important opportunity for AGA to provide input and guidance to the QCA on recent regulatory developments as a precursor to and background for future gas distribution pricing reviews.

Key developments in access pricing regulation

The discussion paper has been developed over a period of significant developments for the future shape and operation of access pricing for regulated distribution businesses.

Four significant developments have occurred. These developments are:

- release of the final report of the Productivity Commission's *Review of the National Access Regime*
- interim Commonwealth Government response to the Productivity Commission report, supporting the broad thrust of the Commission's recommendations and signaling changes to the national access regime and a forthcoming review of the gas access regime
- Western Australian Supreme Court issuing its judgement in *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor*
- release of the draft report of the Council of Australian Governments Energy Market Review

Each of these developments will have critical implications for the future development of access pricing regulation. These developments have emphasised the importance of rebalancing regulation to ensure that long-term interests of the community in service availability and reliability are more adequately recognised. They have also highlighted the importance of regulatory determinations not undermining past investment decisions, and stressed pragmatic approaches to 'workable competition' in preference to abstract theoretical models currently applied. Importantly, elements of the discussion paper appear inconsistent with the fundamental policy implications of these developments.

Final report of the *Review of the National Access Regime*

The Productivity Commission's *Review of the National Access Regime* was the most comprehensive examination of the scope and operation of the current national third party access regime carried out since competition policy reforms were introduced in the 1990s. This section briefly highlights some of the key implications of the final report of the Commission's inquiry for the QCA discussion paper.

The review concluded that there was a significant risk that the current national access regime, including industry-specific regimes such as the National Gas and Electricity Codes, would deter investment in essential infrastructure.¹ In particular, the Commission drew attention to the fact that regulatory risk under current access regimes is unnecessarily high.²

A key finding of the Commission was the need to rebalance regulation to ensure the long-term benefits to the community of reliable and expanding infrastructure services are more adequately integrated into regulatory decision-making. The Commission has noted:

The Commission's recent inquiries have revealed a need to re-balance the emphasis away from achieving immediate gains for users and consumers from existing infrastructure — much of it government owned or previously government owned — to a regulatory framework that will also facilitate efficient investment in augmented and new facilities. In this way, pro-competition regulation is more likely to ensure that Australia has modern infrastructure which is provided and used efficiently, with long-term benefits to the Australian community.³

The Commission found that significant changes are required to both the present national access regime and associated industry-specific regimes (such as the National Electricity and Gas Codes) if significant risks of regulatory error and failure are to be avoided. As the Commission stated in discussing the costs of access regulation:

The sorts of costs discussed in this chapter are symptomatic of the difficulties of regulating access to essential facilities. These difficulties in turn mean that the spectre of 'regulatory failure' looms large.⁴

A core finding of the Commission was that the risk of setting access prices too low, resulting in underinvestment in critical infrastructure, significantly outweighed the potential risk of overcompensating infrastructure investors. Importantly, the Commission recognised that the possibility of regulatory failure and error arose from a number of factors which were not directly related to any failing on the part of regulatory authorities:

Information constraints and imperfect regulatory instruments mean that some degree of regulatory failure is likely in this area almost irrespective of how well regulators perform their task.⁵

The AGA concurs with this finding and recognises that under the current flawed National Gas and Electricity Codes, for example, regulators have a difficult task of reconciling complex and conflicting considerations with inadequate guidance from the regulatory frameworks itself.

A final key theme of the Commission's *Review of the National Access Regime* was the urgent need for measures to facilitate new investment in infrastructure services. The Commission concluded in its final report that:

¹ Productivity Commission *Review of the National Access Regime: Inquiry Report*, September 2001, p.xxii

² Productivity Commission (2001), p.xxi

³ Productivity Commission *Annual Report 2000-01*, February 2002, p.16

⁴ Productivity Commission (2001), p.90

⁵ Productivity Commission (2001), p.91

...support for specific measures to facilitate new investment within access regimes generally, and Part IIIA in particular, has grown during this inquiry. In the Commission's view, the case for such measures is compelling. Thus, the focus for policy makers should not be on whether, but how to facilitate investment.⁶

The Commission considered this to be a high priority action, and urged Australian governments to work together to ensure significant action was undertaken by 2003.

Interim Commonwealth Government response

On 17 September 2002 the Commonwealth Government announced its *Government Response to Productivity Commission Review of the National Access Regime*. This interim response endorsed the majority of the Commission's final recommendations for changes to the national access regime.⁷

The Commonwealth Government response endorsed the Commission's central findings that significant changes were needed to provide better guidance to strengthen the role of commercial negotiation, encourage new investment, and improve the certainty and transparency of regulatory processes.⁸ The Commonwealth Government also indicated that many of these issues would initially be taken forward in relation to the National Gas Code in a forthcoming review of the gas access regime.⁹ These are conclusions and responses that are strongly supported by AGA and regulated gas businesses generally.

The Commonwealth Government response provides important guidance on future policy directions in relation to access pricing regulation. The response modifies a number of the Productivity Commission's proposed access pricing principles, with the objective of ensuring that intrusive and complex cost-based approaches are not encouraged. The response notes:

The two principles proposed by the PC would also risk unduly restricting the regulatory approach, by limiting a decision-maker's scope to introduce or retain alternatives such as price caps or benchmarking. These alternatives may be more appropriate than cost-based approaches for accommodating a particular market's individual characteristics.¹⁰

The Commonwealth has also indicated that it supports continued development of alternative access pricing models. It is clear from this element of the Commonwealth response that it would be inappropriate and inconsistent with the broad policy direction set by the Commonwealth Government to entrench intrusive forms of cost-based access pricing in the distribution network sector. In this context, the limitation inherent in the discussion paper in examining only a small number of slightly different forms of CPI-X regulation appears inconsistent with prevailing policy directions from Australian governments.

⁶ Productivity Commission (2001), p.xxv

⁷ *Government Response to Productivity Commission Review of the National Access Regime*, September 2002, p.1 <www.treasury.gov.au>

⁸ *Government Response to Productivity Commission Review of the National Access Regime* (2002), p.1

⁹ *Government Response to Productivity Commission Review of the National Access Regime* (2002), p.2

¹⁰ *Government Response to Productivity Commission Review of the National Access Regime* (2002), p.5

Epic Energy judgement

A third key development that occurred only weeks prior to the release of the discussion paper was the Western Australian Supreme Court delivering its judgement in *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor*. The AGA considers that given the Court decision, the QCA should consider whether some of the core elements and assumptions of the discussion paper remain appropriate.

The WA Supreme Court decision is a development with critical implications for access pricing, particularly for assets regulated under industry-specific regimes such as the National Gas and Electricity Codes. The case examined for the first time the correct application and interpretation of a number of key access pricing provisions of the National Gas Code (including Section 8.1-2, and Section 2.24, provisions similar to key National Electricity Code Sections 6.10.2 and 6.10.3)

The recent Supreme Court judgment on the appeal has particular relevance to the issues of

- appropriate factors to be considered by regulators in reaching regulatory determinations
- the treatment of past investment decisions (including the circumstances of asset purchases)
- the relationship between economic considerations and broader social and political factors in regulatory decision-making

Many aspects of Court decision support ongoing concerns expressed by AGA and its members that regulatory outcomes and current third party access regimes have failed to provide potential investors in regulated energy infrastructure assets with sufficient certainty and incentives to make large sunk investments.

Workably competitive markets and access pricing

One key outcome of the WA Supreme Court ruling is that it has been established that the National Gas Code and other similar industry-specific access regimes such as the National Electricity Code are designed to promote access pricing outcomes similar to those which would emerge in ‘workably competitive’ market.¹¹ Importantly, the Court signaled that access regulation cannot and should not be expected to replicate outcomes under a perfectly competitive market, a concept which the Court considered a theoretical abstraction.¹² The Court also concluded that a workably competitive market was a process, rather than a fixed outcome, and that it could in theory be consistent with a degree of market power, even over a prolonged period.¹³

¹¹ *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [128]

¹² *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [128]

¹³ *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [128]

Several aspects of the paper appear inconsistent with these conclusions. The discussion paper examines in detail the technical application of the current cost-based pricing approach. A common theme underlying the paper is the now discredited presumption adopted by regulatory authorities that if a given theoretical model (such as the Capital Asset Pricing Model) is applied ‘correctly’, a precisely determinable ‘right’ access price will be obtainable.

A narrow and deterministic approach to the setting of access prices has been a key concern of AGA and its members since the introduction of the current National Gas Code in 1997, and the AGA considers that the retaining of such an approach in an assessment of the form of access pricing in the National Electricity Code is unhelpful and inconsistent with the judgement of the WA Supreme Court.¹⁴ Under an approach seeking to promote outcomes consistent with a workably competitive market, and given the recognised information constraints and possibility of significant regulatory errors, the concept of determining a precise ‘correct’ access price is flawed. Further, as the Productivity Commission has noted, such a prescriptive approach can deter investment:

In relation to the level of prices, attempts to be too precise in removing the potential for service providers to earn monopoly rents carries significant risk for investment.¹⁵

Given these practical considerations and limitations, a range of possible access prices is far more likely to accurately reflect an appropriate outcome. Where regulated businesses propose access prices within a broadly appropriate range, economic regulators should not incur the substantial risk of regulatory failure, or the direct and indirect costs of engaging in exhaustive examinations, by attempting to determine a single point within this range that access prices should be set at. Instead, access prices within such a range should be applied as being consistent with the outcomes likely under a workably competitive market.

Energy Market Review Draft Report

The draft report of the Energy Market Review included consideration of measures to improve network regulation. The draft report made a number of points which are relevant to the QCA’s examination of forms of economic regulation. In particular, the draft report concluded:

Electricity distribution owners should have price, not revenue, caps. Revenue caps bring to distribution networks potential dangers.¹⁶

The draft report points out that in scenarios where demand exceeds forecasts, the potential is created for distribution networks to be left with tariffs too low to augment distribution networks. The AGA considers these conclusions on appropriate forms of network regulation should be heeded by QCA.

¹⁴ See for example *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [143]

¹⁵ Productivity Commission (2001), p.339

¹⁶ *Towards a Truly National and Efficient Energy Market*, Council of Australian Governments Energy Market Review – Draft Report, November 2002, p.57

Comparing alternative access pricing options

The AGA has a number of high-level comments relating to the narrow comparison made between the various forms of cost of service-based pricing outlined in the discussion paper. These comments relate to some of the principles that must underpin a balanced and transparent assessment of alternative access pricing models

Recognising flaws in current access regulation

The AGA does not consider that the discussion paper adequately recognises the fundamental weaknesses in current access pricing methodologies.

These flaws were identified most recently by the Productivity Commission in its *Review of the National Access Regime*. The Commission concluded that the form and application of the current cost-based pricing methodologies:

- risk adverse impacts on new and existing investment
- are information-intensive
- do not create adequate incentives for efficiency improvements
- involve high regulatory compliance costs

Critically, the AGA considers that the discussion paper gives inadequate weight to the Productivity Commission's findings on the high risk of regulatory error and failure under the current 'building blocks' cost-based approaches employed by Australian regulators and outlined in the discussion paper.¹⁷

Scope of comparison of alternative approaches

The paper compares an extremely narrow range of potential forms of access pricing regulation. These include :

- a revenue cap
- weighted average price caps
- hybrid or combined approaches

The AGA considers that this range of access pricing options is relatively narrow, and does not allow a full comparison of the potential merits of alternative approaches. As an illustrative example, the paper does not address a number of additional access pricing models including:

- price monitoring

¹⁷ Productivity Commission (2001), p.90

- price service offerings
- ‘delinked’ productivity-based approaches

The AGA notes that present provisions of the National Electricity Code (for example, Section 6.10.5(a)) limit the scope of access pricing regulation that can be applied by the QCA. Each of the alternative models identified above can be implemented in a manner consistent with CPIX style regulation, and AGA considers each should be considered as future alternatives to cost-based regulation by the QCA.

A final point on the scope of the comparison made between models is that the alternatives are essentially assessed in qualitative terms against the existing approach. The AGA believes that following the approach of both the Productivity Commission and the WA Supreme Court judgement, the appropriate comparison to make is whether any proposed or existing form of access regulation delivers a substantial improvement on outcomes that would be achieved in an unregulated environment, and outcomes similar to a workably competitive market¹⁸

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¹⁸ Productivity Commission (2001), p.346