IPA SUBMISSION ON THE NCC DRAFT RECOMMENDATION

Application for Revocation of Coverage of Parts of the Moomba to Sydney Pipeline System

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Summary

Monopoly means prices are raised above, and supply is lowered below, the levels that would prevail in a competitive market. Regulation of monopoly is one means of countering this. All modern regulatory bodies have the goal of seeking to replicate outcomes that would occur in a competitive market. This requires them to have a clear understanding of the commercial drivers and value adding processes that encourage firms to invest.

By the same token regulation involves losses. Regulations inevitably fail, to a greater or lesser degree, to bring market mirroring behaviour. Moreover, the incentives and disincentives they put in place will often bring about an inferior outcome to that which would prevail in their absence. In addition, regulation involves “paperburden” costs both to the regulators and to the regulated firms and their customers. Nowhere is the existence of such paperburden costs more apparent than in the issues of access that are currently before the NCC, the ACCC and state regulatory bodies.

These regulatory interventions entail costs that must be recouped from customers and, in the case of some regulators’ costs, from taxpayers. Market failure (generally involving some form of monopoly) has its counterpart in regulatory failure (usually involving forcing resource misallocations or deadweight paperburden costs).

While perfect competition is a chimera, where there is a level of rivalry, often referred to as “workable competition”, it is generally considered regulation should be avoided. In the case of the Moomba to Sydney Pipeline (MSP) and Eastern Gas Pipeline (EGP) with ample capacity serving the NSW market, we have the conditions of workable competition. This is especially so since the two pipelines are not beholden to affiliates (AGL’s partial ownership of MSP through its 30% holding in the Australian Pipeline Trust could not force the pipeline to offer favours without defrauding the other shareholders).

The NCC’s recommendations on the MSP and EGP show a poor understanding of cost and benefits from regulation. Indeed, its recommendations appear to be contriving rationales for it to retain control, even though market forces are sufficiently robust and would give a much better outcome than regulation. At this shows a fundamental misunderstanding of the process whereby competition brings the very benefits sought by National Competition Policy.

These deficiencies are serious in themselves in view of the important role the NCC plays on access matters; but they are doubly so since they reflect on the institution's credibility. As such, they threaten to undermine the work the NCC is undertaking in freeing up markets from costly government interference.

For some time now, there has been discussion of a reference by the Government to the Productivity Commission for an inquiry on Part IIIA of the Trade Practices Act. Expediting this reference is important if Australia is to avoid having access provisions re-regulate the infrastructure businesses. We now have experience in the operations of Part IIIA and the Gas Code and these are detracting from national economic welfare rather than adding to it.

In part, this is because the NCC does not have the necessary skills and economics capability to determine the appropriate regulatory regimes for the infrastructure industries; moreover, it (and perhaps the ACCC) is compromised in having both a regulatory responsibility and an analytical role. To provide advice on particular access issues, the Productivity Commission, the country's most expert economic institution, should be given a prominent advisory role.

Issues Raised in the Draft Submission on Revocation of MSP Coverage

The NCC makes its case for regulation of the MSP and the EGP on several broad grounds. These are couched within the framework of the four formal tests for coverage:

- increased access would promote competition in at least one market other than the market for services provided by the pipeline
- that it would be uneconomic for anyone to develop another pipeline to provide the services due to the high construction costs
- risk to human safety from access
- that access or increased access would not be contrary to the public interest.

In marshalling its case for regulation, the NCC raises the following issues:

1. The two pipelines (MSP and EGP) are in different markets (because they tap different supply sources) and there can be no assumed competition between them.

2. The existence of two pipelines and the slow market growth means there is little risk of competition from new pipelines

   2.1 sunk assets mean the two pipelines will be likely to form a market accommodation;

   2.2 both parties will have significant bargaining power in negotiations with producers; monitoring of each other's prices should be easy, and the consequences of prices being driven to marginal cost would be financially disastrous.

3. Gas contracts mean that retailers could not readily switch pipeline because this would necessitate also switching gas source.

4. Capacity of the pipelines is likely to be absorbed between 2005 and 2010 bringing a greater possibility of price increases.

5. MSP's shareholder, AGL, may impact on the availability of surplus capacity.

6. The MSP and EGP's goals are profit maximisation. As they would appear to lose profits by increasing production given the demand elasticities, this together with the high costs of additional pipeline competition makes it likely that the pipelines will engage in informal price collusion.

7. The LECG Submission (on behalf of Duke) has said Coverage might eliminate allocative costs associated with parallel pricing of $9.8 million.

8. It is best to use the National Code for all pipelines since this gives greater consistency and actually facilitates pipeline owners' commercial objectives.

Assessing the Issues Raised by the NCC's Draft Recommendation

The NCC's Approach

In addressing some of these matters, the Chairman of the NCC, Mr Graham Samuels has said[1]

> *"In spite of- or maybe because of - the gas access regime, investment in gas infrastructure is accelerating.*
>
> *"Furthermore, it is important to remember that not all investment is good investment. Critics ignore the effects of NOT granting access – what happens to investment in other markets if access is denied? More broadly, investment is not desirable for its own sake, but rather for the benefits it brings in increasing living standards. Does anyone want or need two electricity distribution networks running down their streets? Does anyone argue in favour of such investment, regardless of whether it is public or private? Society is best served by investment that involves the most productive use of its resources."*

The Chairman goes on to say that the Commission's view is that it should prevent unnecessary duplication of infrastructure and employ a wide *public benefit* test rather than one that examines the issue from the private perspective. He claims a recent Trade Practices Tribunal decision and advice from Professor Phillip Williams supports his view.

This approach underpins the Draft Recommendation, yet calculating such benefits to determine whether an investment should go ahead and the terms of that permission to go ahead is immensely ambitious. It requires considerable knowledge of possible new investments and the constellation of consumer demands and alternatives to those demands. Few would consider a government body either sufficiently well-equipped to make such decisions or appropriately motivated to make them correctly.

In fact, the NCC may have misunderstood the decision of the Trade Practices Tribunal that it draws upon. Thus, the Tribunal is quoted as saying,

> *The Tribunal is concerned with furthering competition in a forward looking way, not furthering a particular type or number of competitors. In this matter, therefore, the Tribunal must be reasonably satisfied that declaration would, looking forward, improve on the competitive conditions in the relevant markets that are likely to exist as a result of the SACL tender process as compared with a situation where there was no declaration*[2].

[1] Address to Utilicon 2000 Melbourne 7 August 2000

[2] Application for Review of the Declaration by the Commonwealth Treasurer Published on 30 June 1997 of Certain Freight Handling Services Provided by the Federal Airports Corporation at Sydney International Airport (2000) ATPR 41-754 at 40,775)

These sentiments illustrate an awareness by the Tribunal of the capacity of regulation to undermine efficiency, an awareness that is not strongly present in the NCC. The NCC, rather than making determinations of what the competitive conditions should be, ought to be concerned with ensuring that such conditions prevail without its intercession, since any such intervention is likely to undermine investor confidence to the detriment of market efficiency.

In November 1999, Duke approached the ACCC with a proposed undertaking on the EGP. In doing so, it sought assurances that its investment, which is expects to be productive for two decades or more and which, like any such long lived investments, is subject to considerable risk, would not also be subject to the "sovereign risk" of regulatory expropriation. In July 2000, the ACCC rejected the proposal claiming to have been given inadequate information. It is likely that information will rarely be adequate for a risk-averse institution and the decision seems to close off such approaches, which were integral to the Gas Code's efficient operations.

In general, it is difficult to agree with the NCC Chairman that investment in gas is accelerating (even if there was the sort of pipeline duplication that the NCC says it wishes to prevent). The statistical evidence[3] is that capital expenditure is declining, especially on transmission pipelines. And much of the recently recorded expenditure has been incurred, for example on the EGP, prior to the current regulatory uncertainty.

MSP and EGP tap different supply sources and therefore are not substitutes

<u>The pipelines operate in different markets</u>

NCC draws on decisions, for example on ports, to argue that the availability of alternate transport routes is vital to a definition of competition in a market. It argues that the Interconnect (between the Victorian and NSW gas transmission networks) is an inadequate alternative to the direct route to Sydney. Others have argued that the indirect route through the Interconnect is important for competition in that its capacity at the margin forces EGP to behave competitively since some of its revenues are at risk.

The NCC quotes users as preferring to have the greater certainty of access at regulated prices. To most users, it is likely that a regulated price and other access conditions would be preferable. A regulated price is a one way bet–the customer cannot be forced to pay the price, while the suppliers are forced to offer it. All firms would prefer such certainty from their suppliers but seldom do governments grant it, since to do so can amount to a regulatory taking with the deterrence to risk taking and flexible operations this entails.

While the MSP and EGP can never be perfect substitutes for each other, this has analogies with other markets, most of which are characterised by what we sometimes

3 See Australian Gas Association Gas Statistics Australia 2000, p58.

call "imperfect competition". The issue is whether the two pipelines have either the ability or the motivation to discriminate against particular users. As each has large amounts of excess capacity and a strong incentive to increase throughput, and since neither has an affiliate which would gain from behaviour discriminating against a rival, there is workable competition.

The pipelines will display inadequate rivalry

The NCC appears to doubt the existence of satisfactory levels of competition unless prices are reduced to marginal costs. Marginal cost pricing signifies a distressed market situation caused by inadvertent excess supply or unanticipated market contraction.

Marginal cost based prices are rare events even in markets where there are high fixed costs, lumpy investment needs and demand swings. Thus, the motor industry has considerable fixed costs but rarely sells cars at marginal price. Instead the vehicle assemblers involve themselves in product differentiation, branding and forward linkages (with retailers). Similar behaviour is seen with airlines, owners of office buildings and virtually all goods and services with high fixed costs. A recent paper by Moran and Hartley *"Marginal Costs and Prices in the Electricity Industry"*[4] addressed these issues of price and market power and examines them in greater detail than is possible in this submission.

Both the two pipelines are seeking contractual solutions to the overcapacity that will prevail for some years in supplying the Sydney market. Pricing action is also inevitable and MSP has responded to the new competition prior to its inauguration by reducing its prices by about 7%.

Collusion to ramp up prices is difficult to envisage without (illegal) agreements. Unlike the England and Wales electricity market, the existence of line-pack in gas offers flexibility to respond to short term high demand elasticity. It is difficult to envisage a situation where one pipeline would acquiesce in lost market because of an innovation by its rival or would refrain from price chiselling or other strategies to win a potentially profitable new customer.

In this respect, the Draft Determination is mischievous in its assertion that the NECG submission[5] says, "while collusion appears unlikely, it cannot be ruled out as a future possibility in the absence of some of price regulation." In fact the NECG submission simply expresses the normal hypothesis that nothing is impossible. Indeed, it goes on to say that such collusion is more likely with Coverage, and its associated comprehensive publication of price information, than without it.

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[4] http://www.ipa.org.au/pubs/Moranwebpapers/Energy15.pdf

[5] http://www.ncc.gov.au/nationalcompet/part%20iiia/gas/Gas%20Folders/Coverage/Eastern%20Application/2nd%20Round%20Submissions/NECG%20submission%20for%20Duke%20&%20EAPL%20(non-CIC%20version).doc

No market is solely reliant on auction price as its clearing mechanism. Upward and downward linkages and contracts, contrary to the NCC view, are normal and healthy means of markets responding to risk and seeking to share it. These contracts are by mutual agreement. Both the pipeliner and the field owner have some market power. The latter can shut in gas if the transport price is too high or divert its gas to some other market. Moreover, as the development of the EGP demonstrates it is difficult to predict when an entrepreneur will see merit in a new development. Certainly in that particular case, the NCC approach of ensuring, "*Society is best served by investment that involves the most productive use of its resources*", would have meant some deferment of the pipeline given the surplus capacity prevailing. It is unclear whether or not that would be proven wise but it is clear that a government entity is ill-placed to make the decision.

The NCC also argues that the part ownership of MSP by AGL means discriminatory behaviour cannot be ruled out. Such discrimination seems to be unlikely. In the fearsomely competitive electricity market, ring fencing even with co-owned distributors and retailers has given rise to no claims of discrimination. Where there is a part owner of a totally separate firm there are even greater assurances against this. Discrimination may offer advantages to one firm but this would be at the expense of other customers. The net effect can be shown to be negative for the supplying firm. Shareholders unrelated to the favoured firm would therefore have their interests prejudiced and Directors would, in their own interests and under company law, be obliged to combat any such activity.

Higher Prices are Likely after Surplus Capacity is Absorbed

In a pure price market where supply and demand responded to changes without any ability to forecast them, and investment was lumpy we would see prices characterised by saw-tooth movements. We would see prices falling to marginal costs until demand caught up, then rising to very high levels until new capacity was introduced, then again falling abruptly to marginal costs.

Such a situation is in fact highly stylised and it is unclear how any new investor would ever recoup costs. The ability to forecast means parties contract in advance, thus giving buyers insurance against abrupt price increases and the incentive to sellers to bring in new capacity.

Higher prices are, however, the trigger for new investment. The tight market conditions these higher prices imply are part of the market process. Trying to mute the prices will reduce investment below the optimum level.

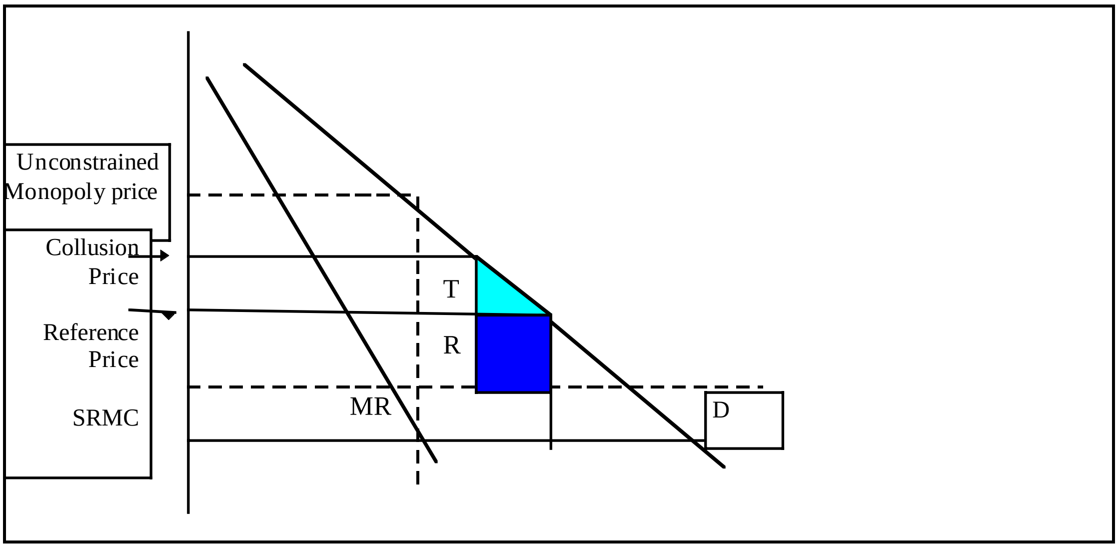
The LECG Estimate that Coverage May Eliminate Allocative Costs

The NCC makes much of the estimate by LECG that anti-collusive prices could lead to a benefit (which LECG calls allocative inefficiency) of $21 million. NCC interprets this to mean a net benefit of $9.8 million after regulatory costs are factored in.

Several points must be made about this NCC seizing on this figure to justify its on-going role.

- First, the estimate was made on a premise that the duopoly would in fact be able to ramp up the price, a view that is confounded by the surplus capacity and the fact that both pipelines are non vertically integrated merchant carriers.
- Secondly, the cost and benefits were based solely on the paperburden costs. As NCC officials should be aware, these costs are only a small part of total (dynamic) costs resulting from regulation. Such dynamic costs include the uncertainty that imposing a regulated regime and a regulated price brings to potential gas pipeline entrepreneurs contemplating other developments. Estimates of these dynamic costs from a specific are impossible, but work undertaken on them has indicated that they are, on average, at least fivefold the paperburden costs
- Thirdly, LECG employ very conservative assumptions in their estimates. Thus, they used 20% of delivered price as the cost of transporting gas. If the NCC estimated transport cost figure (10 %) were used, there would be a negative benefit even in the very restrictive terms used.
- Finally, the LECG allocative inefficiency notion is different from the welfare gains concept that the NCC employs. Instead of the gain of $21 million in the example offered by LECG, the actual welfare gained from the NCC setting a reference price below the level assumed to prevail under collusive pricing is $1.12 million. This represents the benefit from the regulator accurately correcting the monopoly price. The loss from regulation is therefore $10 million even excluding the overwhelmingly important dynamic costs. This is because the diagram on p 56 of the LECG submission includes as costs the area above the long run marginal cost curve.

  In fact, long run marginal cost is a highly flexible concept. The regulator's reference price should be set at that rate to the extent the regulator meets its claimed goal of replicating the price that would emerge from a competitive market. Hence the shaded area under the demand curve on p. 56 overstates the impact of the regulator. The welfare loss is more accurately defined as the (Harberger) triangle between "Collusion Price" and "Reference Price". This works out to be $1.12 million. In other words, the welfare loss is defined by the difference between the perfect regulator's market price and the monopoly price; this excludes the shaded rectangle (R) between SRMC and Reference Price in the diagram, reproduced below.



Concluding Comments

We now have experience with the operation of the present regulatory arrangements for gas. They are not achieving the benefits that governments hoped to achieve. Instead of facilitating building of new pipelines, the regulations are providing an opportunity for vested interests to obtain advantages on a particular pipeline rather than a means for encouraging an efficient expansion of the pipeline network.

The reasons for this outcome may reflect issues concerning the regulatory framework itself, Part IIIA of the Trade Practices Act and the Gas Code, as well as the regulatory institutions charged with administering them.

The gestation period prior to coverage being approved is averaging 16 months (AGA Gas Statistics, 2000). This, Duke's unhappy experience in seeking an undertaking for the EGP and the propensity for the ACCC to require a proposer to reduce the price below that which it and willing buyers are ready to accept (e.g. with the Central West Pipeline) offers little confidence in the processes whereby prior approval may be granted by the ACCC.

Access regulation involves an incursion on an owner's property rights. As such it should be carefully limited if we are not to seriously impair the incentives that are afforded by private property rights. While it is desirable that businesses formerly owned by governments or established on the basis of some form of exclusive franchise should be subjected to access and price regulation, in the case of new pipelines which enjoy no government favours, such regulations will reduce entrepreneurial activity. This will be to the detriment of the economy as a whole and particularly to the parties directly affected. No major commercially based pipeline can proceed in the face of uncertainty about how the regulators will require its capacity to be priced.

The MSA and EGP pipelines illustrate a further form of risk-aversion on the part of the regulatory authorities. The NCC's determination to require regulatory coverage of pipelines that compete for particular markets, even if they are parallel, leaves scant scope for the sort of light handed regulation that the Hilmer report foreshadowed.

Accordingly, the IPA calls for a review, preferably by the Productivity Commission into the operations of Part IIA of the Trade Practices Act and associated regulations in the Gas Code