Submission

Review of the National Access Regime

– Inquiry by the Productivity Commission into the operation of Clause 6 of the Competition Principles Agreement and Part IIIA of the Trade Practices Act 1974

Prepared for

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Summary

This submission argues that the scope of application of the national access regime should be narrowed and that its form should be changed in order to make it more cognisant of private property rights and to reduce the extent of the disincentive it poses toward private investment.

Recognition and preservation of private property rights are fundamental to a properly functioning economy and society. Abrogations to those rights necessarily bring with them cost in terms of economic efficiency as well as personal freedom. For this reason, a highly cautious approach should be taken when adopting regulatory mechanisms, like access regimes, which are intrusive on property rights. This is consistent with the Commission's view expressed in the Position Paper and it underlay the recommendations of the Hilmer Report of 1993, that gave rise to current access regulation.

In relation to the scope of access regulation, we believe that two key areas require reform. First, as maintained in the Hilmer Report, access regulation is only justifiable for vertically integrated facilities; nor should it be used for vertically integrated facilities that are ring-fenced. While the owners of such facilities that are bottlenecks may have incentives to engage in monopoly pricing behaviour, they have no incentives to deny access to their facilities; combating monopoly pricing of access is more appropriately dealt with by intrinsically lighter handed prices surveillance legislation. We have addressed, in detail, the arguments against adopting such a course that were presented by the Commission in its Position Paper.

Secondly, the concept of "bottleneck" facilities used in the context of access regulation should be defined more stringently and limited to bottleneck facilities for products delivered into markets and not include facilities that are bottlenecks for producers into a transmission facility. In this as with other issues there is a need for greater consistency between different access regimes.

To the extent that alternative regulation is required in relation to facilities that would be excluded from access regulation under our proposals, a reformed prices surveillance mechanism, broadly as recommended by the Commission in its draft report on the Prices Surveillance Act, would in general be sufficient. Some specific proposals are made in relation to additional inclusions in such reformed regulation. We note also that Part IV of the Trade Practices Act is available to deal with abuses of market power.

Finally, specific pricing principles in both Part IIIA and in any successor legislation to the Prices Surveillance Act should be adopted in order to reduce the degree of uncertainty associated with the application of pricing regulation. The Commission's proposed principles form an appropriate foundation, but a number of additional principles should be explicitly incorporated in order to reduce to a minimum the "chilling" impact on investment of such regulation. These include the explicit adoption of a light-handed approach and recognition of the need for price regulation to

be fully incentive compatible.

1. Regulation of Essential Facilities and the Preservation of Private Property Rights

1.1. Private ownership and the efficient use of property

1.1.1 The recognition of individual property rights and efficiency

The importance of private property as a means of ensuring the most productive use is made of a society's assets is a continuous thread running through the law and philosophy of western civilisation. It featured prominently in the writings of Aristotle and Justinian. In the modern era the importance of private property is associated especially with John Locke, whose preferred approach was to convert all commons to private property. The logic behind this is based on his view of the former as inherently unstable and likely to be inadequately cared for.

This same philosophy became fundamental to the Constitutions of most modern states, commencing with the USA. Contemporary constitutions seek to create conditions that best favour liberty and the pursuit of happiness. As it moved geographically westward, the USA used land sales and grants to give expression to Lockean principles of privately vesting ownership to unoccupied lands.

This had its policy basis in the "takings" clause in the US 1791 Bill of Rights ("…nor shall private property be taken for public use without just compensation"). The "takings" clause sought to enshrine the notion of compensation for government acquisition of private property. It also provided the philosophical underpinnings of a policy that saw government ownership as both a poor use of property and carrying the risks of tyrannical rule. That clause has its equivalent defined by the High Court in the Australian Constitution (section 51(xxxi)).

For much of the twentieth century, the notion of private property being the key to on-going prosperity was subject to considerable dispute. There is now no reputable body of opinion that maintains a contrary view to that position. This is reflected in the submissions to the current inquiry–even those favouring increased regulatory intrusion virtually all claim that the intrusion they favour will reduce costs without having any marked impact on efficiency in other directions. Our view is that all such interventions are likely to have pernicious effects and that efficiency can only be ensured if governments consistently pursue the principle of minimising any regulatory restraints on the uses and transfers of private property.

1.1.2 Regulation of the uses of private property

Regulation of the uses to which property rights may be put reduces the value of those rights. It means the assets and their associated labour and raw materials are used less than fully productively. Such a reduction in the value of assets' output, as the Commission notes, has a "chilling" effect on investment.

This is just one of the deleterious effects likely to follow from intervention into the rights that private owners have in the use of their property. Also likely is a sub-optimum level and pattern of operation and maintenance expenditures, as well as the otiose need for expenditures on regulation and associated paperburden costs. Any government action that might diminish the value of private property rights should, therefore, be introduced only after the government has assured itself, to a high degree of certainty, of the existence of countervailing benefits.

Government intervention in the normal interactions between buyers and sellers and associated parties is significant in the degree to which such intervention might undermine property rights and hence investment.

1.1.3 Regulation of entrepreneurial infrastructure

In Submission 18, the IPA argued that infrastructure property developed without the benefit of a government franchise or any other support ought not to be subject to declaration or other common carriage restraints.

Thus, a business may establish a gas or electricity line without any assurances about its revenues or without any protection from rival lines or from rival facilities (e.g. a generator located close to a load which reduces the need for the transmission line). In such a case, the IPA view was that *prima facie* no obligations in terms of price or other conditions need be imposed. The argument runs that no franchise was established, life proceeded before the facility was built and it is up to the various parties to see to the protection of their own interests. The facility owner must seek to ensure it links supplies of energy with customers prepared to pay the necessary transportation price. The customers need to ensure they have the use of the facility at a price that they find acceptable; and the energy producer needs to be certain it has use of (or can purchase use of) the facility to land its energy at a competitive price.

This describes the normal means of conducting business in a free-enterprise economy. No responsible voice would argue that the producer–even the producer of essential foodstuffs–should be obliged to make these available at government determined prices. Competition, or the threat of competition, is the regulator.

This is the approach adopted in the case of "entrepreneurial interconnects" in electricity. These lines, whose conditions of use have been pioneered in Australia, bid to be dispatched in the same way as power stations bid. In supplying a market, they are not "essential", although they may have a high degree of essentiality as means of transport for a particular supply source. Their owners have full capability to allow them to link in full or in part two markets and, as with power stations, they will operate only if this is profitable. One such link is now in operation between NSW and Queensland and another, between Victoria and South Australia, is under construction. Basslink between Tasmania and Victoria is also planned to be an entrepreneurial link.

Entrepreneurial interconnects (as was previously the case with integrated electricity systems) comprise an example of a utility function that was once considered to constitute a natural monopoly being competitively supplied. This has been brought about as a result of the conditions under which the lines can be remunerated, their controllability (because they are direct current), together with the demonstrable ability of many different lines capable of delivering power and controlled by an independent system operator.

By contrast, "regulated" links are financed from a compulsory levy on customers or indirectly through charging customers through fees on generators. As such they have no real test of market acceptance and their merits vis-à-vis no link, seeking out disconnectable loads or a stiffening of local generation, have to be assessed by the regulatory authorities. Understandably the test is relatively strict.

1.2. Examining the case for regulation of essential facilities

1.2.1 Law and efficiency in property rights

There are two sets of arguments that can be advanced in favour of regulation of assets as essential facilities. The first is based on the development of the common law as outlined by Professor Richard Epstein[1]. The second is contained in the submission to the Productivity Commission (n. 53) by Dr T Dwyer and R K H Lim and rests on the notion that the "essential facility" only obtains a right of way over others' properties by government action and owes a corresponding duty.

Epstein points out that resolving clashes of rights is the fundamental purpose of property law. Sorting out the rights of different property owners where those rights are in conflict has been the task of courts throughout the ages.

One common task, central to carriage of goods to markets, has been preventing property owners from exercising hold-out advantages. In 1904 in *Madison v. Ducktown Sulphur, Copper & Iron Co* a Tennessee court denied compensation to the landowner whose land was worth $1,000 who sought to profit from his position vis-a-vis a mine worth $2,000,000.

In Australia, these issues are resolved by the Mining Warden system. The Mining Warden has authority to determine the compensation due to the surface owner as a result of a miner having discovered (and subsequently been awarded ownership of) a

[1] Richard A. Epstein *Principles for a Free Society*, Perseus Books, Reading Mass, 1998

valuable mineral deposit, and then proceeding to develop it making use of the landowner's property. The Mining Warden determines what compensation is due to the surface owner. This does not involve giving the latter any stake in the mine itself. Nor does the miner acquire any property rights over the land. Instead he has an "easement" that allows use of the property in a reasonably non-intrusive manner.

While the conflict would be avoided if the property owner of the surface land were also to enjoy beneficial ownership of all that is under and above his land, as was the case in Roman law[2] this is not a specification of property that is likely to encourage the optimal allocation of resources to the search for new value. If land rights were to be all-encompassing, this would convert the land-owner into a real-estater, providing excessive incentives for passively holding land parcels rather than seeking to prove up their value. It would be the equivalent of granting some rights to future inventions to people who have no skills or can undertake no tasks that will make those inventions any more valuable or expedite their discovery. Thus, the landowner's ownership of the mineral wealth beneath his land would provide no encouragement for specialist mineral explorers to emerge. That form of all-inclusive ownership vesting would make even less sense in the case of non-invasive use of the electromagnetic spectrum in the air space above a property.

As a result of the need to ensure that optimal effort is expended on the discovery of, and profiting from, value, property rights are not and cannot be as simple as those that are coincident with the ownership of the land.

1.2.2 Obligations of essential facility owners

The IPA Submission argued strongly that there is a key distinction between a facility that has been developed without any protection or support from government and one that has been developed under some sort of franchise (or, like much Australian infrastructure, by the government itself). The submission argued that those undertaking a development of the former kind need not and should not face regulation regarding access or price.

Epstein does not consider the distinction between a franchise protected "essential facility" and one that developed without any privileges as being as crucial as this. Much of his analysis (like the key English and American cases that established precedents) rests on the seventeenth century tract by Lord Matthew Hales *de portabis mari* ("concerning the gates of the sea"). In that tract, which was not published until the 1780s, Hales argued, that an asset (he was discussing cranes in ports) can be "affected with the public interest" either "because they are the only wharfs (sic) licensed by the queen" or "because there is no other wharf in that port".

[2] *cujus est solum, ijus est usque ad caelum et ad inferos*. sometimes translated as "whose is the soil is also that below and above it from the core of the earth to the heavens".

It is clear however that there is a vast difference between the two situations. Where the monopoly is created by law, the monopolist is bound by the terms of the original grant which include the *quid pro quo* for that grant. Where the monopolist has seized his position by spotting an opportunity and offering value, the government regulation is pure coercion.

Although not accepting a sharp dichotomy of approach between government supported and purely entrepreneurial infrastructure, Epstein argues "….regulation must be justified on the grounds that any monopolist charges too much and sells too little relative to the social – that is the competitive – optimum. But even when true, the case for regulation is hardly ironclad. The situational monopoly may confer only limited pricing power, and its durability could be cut short by new entry, or by technical innovation. Regulation could easily cost more than it is worth, especially if the regulation entrenches present forms of production against the innovation needed to undermine its economic dominance." (p. 284)

1.2.3 Regulation as the price for government services

Dwyer and Lim (Submission 53) argue that it may be reasonable to allow the market to set the rates for infrastructure but that the market comprises more than the investor and the user. They suggest it also comprises the Crown (as granter of the franchise) and the landholders giving or being forced to give access and other potential infrastructure providers. This starts to resemble the dilution of control and subsequent fuzzy policy implications that is often seen when the firm is viewed as a series of "stakeholders".

The Dwyer and Lim submission focuses on property rights but assumes all things are owned by someone. In fact the cardinal rule of property rights is that all things <u>of value</u> must be owned. Things which have no value need not and usually should not be owned by anyone. Their ownership becomes vested in those who discover the value.

This is the accepted procedure for patents and copyright. The undiscovered or uninvented material is unowned until discovered or invented, after which the discoverer/inventor obtains (limited) ownership rights.

This is also the principle behind mining law in most common law countries. The crown is the theoretical owner of the minerals that are undiscovered and charges a "royalty" on them. But that charge is reasonably well known in advance and is fixed. The discoverer of the minerals obtains substantially all the value from them. Were this not the case, the incentives would be wrongly placed: the government and/or landowners would receive windfalls without expending any effort. This misdirection of rewards for effort and risk taking would cause sub-optimal search and development activity.

Similarly, the mineral product needs to be transported over a landowner's property. As earlier discussed, while it is reasonable that the landowner be fully compensated for any inconvenience thereby caused, to give the owner more than this would again overcompensate him and, accordingly, undercompensate the explorer. This would lead to a misallocation of resources.

There are situations where the compensation warranted to the landholder is greater than the value of the facility which uses it. This may certainly be the case with inner city property. Where the government acts under eminent domain to force the sale of property, for example, to build a highway, the compensation in such cases is necessarily very high. Hence, as a result of the higher costs, there are fewer such facilities built (in relation to the demand for them) than would be the case in a more remote area.

As already discussed, where there are conflicting property rights over a particular piece of land, it is often not possible to allow a simple bargaining process between the rival uses (if the infrastructure does in fact cause a reduction in other possible uses–some access like that for telecommunications may not). The landowner is in a hold-out position. While a successful development, say of minerals, may be highly profitable, the general situation of the industry is that there are no economic rents.

This has a bearing on the sort of policy options advocated by some. It is possible for the state to seize rents from monopoly privileges the infrastructure owner is given. Indeed, the very definition of economic rents recommends this as the correct course and seizure could not have any adverse effect on economic activity. But it is difficult to identify any such rents ex ante. There may, of course, as in the case of a mineral discovery, be very substantial rents *ex post* but taxing these will curtail their future availability. Unless there are a number of infrastructure owners spotting an exceptionally profitable opportunity at the same time and only one development can proceed, the rents are not present *ex ante*. Attempts to anticipate them with a tax will constitute discriminatory investment policy, reduce investment and diminish economic welfare.

Dwyer and Lim are incorrect to claim that government easements provide a franchise to the infrastructure builder. The easement through which the conduit runs is not the property of the infrastructure builder. It belongs to the state and is available to other infrastructure providers as long as there is space.

Dwyer and Lim recognise the likelihood of hold-outs and maintain that this gives rise to services provided by government. They seem to be arguing that the government therefore has the rights to the rents. If the government does have such rights (and by dint of its monopoly over the use of force it could readily assume them) to exercise them would place it in a parlous position. Governments are in competition one with the other to attract investment and to ensure they maintain the environment that allows their citizens to prosper. If they purloin the value from their essential administrative role that prosperity will be attenuated.

Dwyer and Lim destroy their own argument for efficient outcomes when they say:

> *"Moran and others forget that the underlying property in question belonged to the Crown as landlord on behalf of the people in the first place. … If the Crown, on behalf of its subjects, says to an infrastructure developer 'you may have these easements for your infrastructure on condition that, having been granted free access, you will not abuse your conferred monopoly, by charging more for access than your costs.' What is there to complain of?"*

There is nothing to complain of when the ground rules are fully spelt out, but a nation that seeks at the outset to reduce entrepreneurs' opportunities to profit from spotting market opportunities will see less such activity. If all infrastructure returns were to be capped at a rate of return that the government or its agents consider appropriate, there would be less of such infrastructure built. There will certainly be less of the more risky infrastructure that has uncertain returns. In terms of the infrastructure built, we would therefore see a concentration on serving existing known markets with known resources. We would see far less activity on projects that entailed forecasts of demand growth that contain considerable up- and down-side uncertainty. Not only does this deny the economy worthwhile ventures, but the ventures denied are those that improve its economic resiliency and ability to adapt to change.

As Thomas Friedman points out in *The Lexus and the Olive Tree*, government actions to reduce profitable opportunities will spark swift retribution in today's wired world. Information concerning increased government intervention is quickly transmitted through such agencies as Dun and Bradstreet. Capital, and perhaps scarce labour, will shun the country whose government acts so irresponsibly, forcing it back into line or resulting in the country facing a lower level of prosperity. This discipline of globalisation does much to reduce the scope governments have to intervene within an economy. It is a benefit in that it sharply constricts the ability of governments to tyrannise their own or foreign citizens.

However, it is not new. The growth of the common law itself is due to the internationalisation of commerce in the Middle Ages. The *Law Merchant* developed as a means of allowing trade to take place. Governments that favoured some parties, either on their own behalf or on behalf of their citizens, found their lands were less patronised by traders and that some of their more productive citizens migrated. Without anyone planning it, the law developed as a constraint on government action. It remains so today.

1.2.4 Allocation of franchises that have economic rental value

Dwyer and Lim suggest that the Crown, as the owner of the land, should "play off would-be monopolists against each other by offering the franchises on a leasehold basis." This is the procedure in some areas, notably water. It is a sensible approach where an opportunity is common knowledge and where there are many developers vying for it. Thus, having an auction where there is known or widely perceived value (as in the electromagnetic spectrum) is the best way to allocate a resource.

Some have suggested this as an approach that should be used for the allocation of mineral exploration licences. But the value placed on such licences, like that on yet-to-be-discovered technological innovations, is normally zero. Similarly, in the case of a right of way that is not presently being used, the value is likely to be zero. Only when an entrepreneur engages in research of the opportunity it offers is a value likely to be placed on it. And if, after demonstrating such value, the entrepreneur is obligated to bid on equal terms with rivals for its use, he will have expended resources for no purpose. Search activity to discover such value will dry up and the community will be the worse off for it.

Dwyer and Lim also argue that although there are gains from trade as long as the trade is mutually agreed to, the gains are not necessarily efficient. They suggest that all that the gains offer is something to the buyer that is better than his marginal expenditure on his next best preference. They argue this may not be optimal.

This is a statement with sweeping consequences. It is difficult to say whether any price is optimal but achieving the optimal price is what all governments that have implemented price control have aimed for. None have ever achieved that aim.

The corollary is that some body other than the interplay of market forces determines the level of price– an outcome certain to engender disaster. In this respect, they quote Hayek in a way that seeks to demolish the *laissez faire* approach but ends up sustaining that position. They quote him (p.8) as follows:

> *"The chief point to remember ….. is that it is not monopoly as such but the prevention of competition which is harmful. Just as nobody would dream of attacking the 'monopoly' price of an artist or surgeon, so there is nothing wrong in the 'monopoly' profits of an enterprise capable of producing more cheaply than anybody else. Sometimes the appearance of a monopoly may even be a desirable result of competition. If such a position appears objectionable to many people this is chiefly due to the false suggestion of the word monopoly that it constitutes a privilege. But … the fact … that one producer (or a few producers) can meet the demand at prices which nobody else can match, <u>does not constitute a privilege so long as the inability of other to do the same is not due to their being prevented from trying</u>. The term privilege is used legitimately only to describe a right conferred by special decree (privilegium) which others do not have, and not for an objective possibility which circumstances offer to some but not others." (Emphasis added by Lim and Dwyer)*

In fact such a monopolist as Hayek praises would be an infrastructure developer who spots an opportunity for producing a good that is highly prized by the consumer and for which a premium price can be charged. Premium prices and high profits are the normal reward for successful innovatory activity. The infrastructure developer in Australia would have no franchise protection and would always be vulnerable to competition.

There is also a response to a lengthy quote from the IPA (Moran) submission which extolled the virtues of property rights. The authors suggest, somewhat redundantly that some property (e.g. slavery) is not sacrosanct and make a strange interpretation of the regulatory enactment of the British Government[3] to abolish the freehold rights (curiously, they put it as enforcing the “leasehold enfranchisement”) as proving that property rights can be modified without apparent serious harm. The abolition expropriated the property rights of the freehold owners, thereby enhancing those of the leaseholders.

Of course, it is true that Governments frequently play fast and loose with private property. Even the US Supreme Court in *Lucas v North Carolina* refused to acknowledge a “taking” unless it was total. However, the point is that a few grasshoppers do little damage to a crop but a plague of locusts destroys it. Too much interventionary action shifts a nation to the political and economic periphery. Very few politicians find it possible or palatable to totally refrain from overriding the established law but the difference between nations like Switzerland, the USA and Singapore are considerable when compared to countries like Sierra Leone, Malawi, Rumania, Myanmar and other unsuccessful economies. The former group of countries is near the top and the latter near the bottom of the economic freedom league compiled by a group of “think tanks”. Countries are ranked according to criteria in which the degree to which their economies are characterised by considerable government intervention. There is a very strong correlation between economic prosperity and economic freedom.

1.3. The upstream and downstream nature of bottleneck facilities

1.3.1 Regulation of bottlenecks

Most submissions to the Review of Part IIIA, argued that the use of access arrangements is an infringement on property rights of the owner and needs to be reserved for cases where the damage this does is over-compensated for by the improved community welfare it brings. The underlying notion of welfare is a broad one, generally incorporating the gains to individuals in obtaining cheaper access, offset by the deterrence effect of the usurpation of property rights which that improved access brings in the particular case to which it applies. Many submissions refer to the fact that Part IIIA should apply only to bottlenecks.

One of the issues for clarification is what constitutes a bottleneck. In this respect,

[3] A measure enacted under Prime Minister Major, not as the authors maintain, Thatcher

- Hilmer called for an access right where this is “essential to permit effective competition”
- Clause 6(1) of the CPA calls for legislation to establish a regime where access is “necessary” to permit “effective” competition in a downstream (closer to the customer) or upstream (closer to the supply) market
- criterion (a) of the competition test is much broader, seeking only that access “would promote competition in at least one market (whether or not in Australia) other than the market for the service.”

In the current telecommunications inquiry, the ACCC is telegraphing a possible need to control the content of broadcasting where this is considered a bottleneck[4]. This is notwithstanding the existing regulations, which confer great powers on the ACCC to:

- endorse and make the industry codes that facilitate access
- accept or reject undertakings relating to the charges and terms and conditions for access
- declare services under the Act and establish principles for charging and other terms and conditions.

The government/regulator is often increasingly driven to augment its control once it commences along the path[5]. This may be because of a different view between itself and the facility owner over what constitutes commercial behaviour. For example, the prices the government dictates for access may make it unremunerative for the access supplier, in its own view, to undertake the investment the regulator considers to be appropriate. The regulator responds by <u>requiring</u> the investment <u>it</u> believes to be warranted[6].

This illustrates the inherent dangers of snowballing regulatory intrusion once intervention takes place. It was such scenarios that led Hayek and others to consider regulation (then usually referred to as “planning”) to lead inexorably to the Road to Serfdom.

1.3.2 Narrowing the definition of bottleneck

Some reduction in the potential for excessive regulatory intervention can be brought about by more tightly defining when regulation may take place. The term bottleneck is widely used as synonymous with natural monopoly where a single production unit is the least cost means of supply. But “bottleneck” can be a far wider concept since it will normally be determined empirically - if only one supplier is present, this is considered to be *prima facie* evidence of an essential service.

[4] Submission 16 to the Productivity Commission’s Telecommunications Inquiry.
[5] The ORG in Victoria released over 200 documents to regulate electricity and gas over the past five years. These are listed in the Appendix
[6] Ostensibly, this is specifically ruled out in by some Australian access arrangements, e.g. the National Gas Code (s 3.16).

Bottlenecks should focus upon an essential facility to a market. They should not apply to a facility that serves a supply source, unless the source itself is a sole supply to a market. In this respect, we agree with the NECG Submission

> *"Specifically, access regimes operate to address the situation where an upstream firm controls an essential input for downstream firms (i.e. an economically significant input that cannot efficiently be substituted against) and the inputs cannot easily be replicated."* (Sub. 39, p. 10)

The same sentiments are expressed in King's submission which argues for a replacement of s 4G2(a) and (b) with

> *The Council cannot recommend that a service be declared unless it is satisfied that (a) access (or increased access) to the service will substantially increase competition in the market for a final good or service.* (Sub 1 p. 10)

Hilmer too in addressing facilities "that cannot be duplicated economically" offered as examples "transmission grids, local telephone networks, major pipelines, ports and airports".

In some cases it is unnecessary to distinguish between facilities constraining production and those constraining customer choice. In the past this was certainly the case with telecom networks and electricity, where the assets were vertically integrated grids. The lines parts of the networks remain bottlenecks in certain cases. But this is hardly so with telecoms where the monopoly, if it exists at all, is now confined to the "last mile". Similarly, with electricity, new transmission lines can be developed and totally isolatable direct current lines are now in place in Australia.

It follows that there should be some limitation on the notion of bottlenecks to supply that justify regulation. The true bottleneck is only a monopoly facility into the market. Facilities from a specific supply source, like gas gathering lines, need no regulation and are not presently regulated. It should, however, be made explicit that access requirements should be confined to bottlenecks to the supply of the downstream (final customer) market.

To regulate upstream facilities would reduce the incentive to build them in the first place. Potential suppliers in these situations should be left to negotiate as commercial entities without government assistance. In the case of a supplier seeking access to a piece of infrastructure, the supplier would (or should) be fully aware of the ownership of the bottleneck to the market place prior to embarking upon expenditures.

The upstream infrastructure owner has no monopoly in supplying the market, is in competition with other pieces of infrastructure (or alternative products), and therefore must price competitively. If the particular piece of infrastructure is operating near capacity and several suppliers are seeking access, the owner can extract premium prices. But such prices are only a means of efficiently rationing the capacity and actually act as an incentive to have either the owner or others build additional capacity[7].

These matters were addressed in the case of the Duke Energy gas pipeline from the Bass Strait and the EAPL pipeline from the Cooper Basin. It will be recalled that both facilities are designed to serve the Sydney market. The NCC required coverage over Duke and rejected EAPL's application for rescinding coverage over its own facility.

It justified these decisions on a number of grounds. Among these were that the NCC argues that EAPL was not a stand-alone entity. AGL's 30% ownership made it an influence. The NCC argued that this made the firm part of the AGL family and therefore biased EAPL against other users. Acceptance of this view would raise much wider issues. In particular, it would imply that:

- the remaining 70% of shareholders are being denied value as a result of the favouritism.
- the directors, other than those who are also AGL directors, are acting at variance with their duties to the shareholders under the ASIC.

It is almost certainly untrue that the majority shareholders in EAPL would be so gullible as to be hoodwinked into allowing a minority shareholder to make off with a larger share of profit than their equity stake warrants. Even if this were to be the case however, it is the role of government policy and legislation not that of a regulatory "court" to rectify the position.

The Moomba to Sydney pipeline case illustrates the cost of poor decisions. Prior to the Duke Pipeline contesting the market, the price charged for haulage was 71 cents per Gj. Once Duke was in place and offering robust competition, EAPL dropped the haulage price to 65 cents per Gj. Further reductions may have taken place as the competition developed. It is, however most unlikely that the competition would have forced the EAPL price down to the 46 cents per Gj that was required by the ACCC.

Given a regulator able to exercise the finest judgement and determine a level of prices exactly equal to that of a competitive market, regulation would be costless (but for its intrinsic costs). But the likelihood of it occurring is remote.

Regulators tend to play to the gallery of public opinion and reduce the regulated prices below those that would otherwise prevail. They cannot, of course, do damage by raising the price above that which would otherwise prevail, because buyers are not obliged to pay the higher price and the actual price would be below that stipulated in such a case.

Often the regulators will claim as a saving the lower prices they have required, but the

[7] In addition, the rights to the transport capacity may belong to others rather than the owner. In that case the rights may be accompanied by a transport rental payment. The rights might be converted into a financial right, with the supplier who does not have rights having his product carried but paying the owner of the rights any congestion fees (i.e. the difference between the price at the node where congestion is not present and that which exhibits congestion.)

actual “saving” is merely a transfer. Its cost is reflected firstly in the inefficiencies that a price distortion imposes on the regulated supplier and secondly via the demonstration effect, the “chilling” impact on new investment. Thus, in the case of the EAPL, at first glance, the ACCC had handed a windfall of a price reduction of 30% to the users of the pipeline. But, like any such government provided gifts, the payment will be extracted later in terms of misallocated investment. In the event, the May 2001 decision by the Australian Competition Tribunal is likely to bring an unraveling of several other gas transmission declarations.

1.4 Setting pricing principles for regulators

These issues of regulatory incentives and likely regulatory performance give rise to the question of whether it would be useful to establish pricing principles for regulatory agencies to follow. In general, we believe the use of explicit pricing principles can be a useful mechanism by which the regulatory price-setting powers may be constrained. This constraint can potentially function both in terms of the initial decision-making by the regulator and in providing to regulated parties a basis upon which to challenge specific regulatory decisions.

However, experience suggests that the extent to which pricing principles can effectively be used for these ends in practice is somewhat limited. On several recent occasions in Australia, pricing principles designed to guide regulatory agencies have been specified. For example, the Victorian regulator was obliged to establish the post 2001 price re-set for the electricity distribution businesses on a “CPI-X”, rather than a “cost of service basis”. On this occasion, as in other cases, the regulatory authorities found a pretext to apply a “cost plus” pricing rule, which disallows expenditures they consider to be excessive. The likelihood of such actions being taken by the regulator is ever-present, both due to the information requirements associated with adopting efficient pricing regulation and with the political incentives to ensure that there is no appearance of “monopoly” profits being retained by the regulated entity.

Given these factors, we believe that careful consideration must be given as to the shape of the specific pricing principles that are adopted, and that relatively detailed requirements are likely to be necessary. That said, the use of pricing principles is a second best solution, one that is inferior to a narrower application of access regulation. But, there are no obvious countervailing costs associated with the adoption of pricing principles, with the possible exception of the possibility of a false complacency developing regarding the “precision” or effectiveness of the regulation. On balance, therefore, we are cautiously supportive of the adoption of pricing principles. This point is developed further in Section 4.2, below.

2. Integrated vs non-integrated facilities

The above has argued that the definition of “bottleneck” can and should be narrowed to focus solely on the question of competition in downstream markets, rather than referring also to upstream markets, as at present.

A second area in which consideration can be given to narrowing the range of “bottleneck” facilities to which access regulation applies is the exclusion of facilities with ownership that is not integrated with the ownership of downstream facilities.

The Productivity Commission’s issues paper raised this matter, asking:

> *“Should vertically integrated bottleneck facilities be treated differently than non-integrated facilities? Is the real concern underpinning access regimes denial of access, or the price and conditions of access? Are the two concepts separable from a regulatory point of view, or should they be addressed in tandem?”*[8]

While a significant number of submissions to the inquiry argued strongly for the exclusion of non-integrated facilities from coverage under access regimes, the Commission’s March 2001 Position Paper concluded that coverage of non-integrated facilities should be maintained. The Position Paper further includes a “tier 1” recommendation (5.2.) that:

> *“there should be explicit recognition in Part IIIA that the regime covers eligible services provided by both vertically integrated and non-integrated facilities”*.

The Commission’s reasoning, as set out in pages 105-107 of the Position Paper is based on the following five contentions:

- Removal of non-integrated facilities from coverage would imply potential inconsistencies in approach between integrated and non-integrated facilities;
- Incentives for facilities to separate to avoid access coverage may thereby be created. This would be sub-optimal to the extent that integrated provision provides economies of scope or other efficiency benefits;
- Control over “transitional” situations would be weakened (e.g. government facilities that had been formally separated but where exclusive dealing or other contractual arrangements might undermine the separation);
- Evasion by owners structuring their affairs to “walk the line” on separation would occur, leading to ongoing gaming/enforcement problems; and
- Behaviour that is socially costly would evade “the main remedy available in the Australian competition policy regime”, while no social benefits can be identified from this outcome.

We discuss these lines of reasoning critically in the following sections.

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[8] National Access Regime: Issues Paper, p17. Productivity Commission, 2000.

2.1. Inconsistencies of approach between integrated and non-integrated facilities

This concern is predicated on the general requirement to ensure equality of treatment under the law, together with the need to avoid the creation of market distortions due to the inconsistent application of regulation. However, careful consideration casts doubt on the applicability of these perspectives to this issue.

As argued earlier in this submission, the application of an access regime itself represents a departure from the general view that governments should not interfere with the rights of property owners by decreeing aspects of their use of the property. Both the Commission and the majority of parties making submissions have explicitly noted that, as a result, a cautious and minimalist approach should be taken. Thus, from an access perspective, unless it can be shown that there is a compelling case for extending coverage to non-integrated facilities, the presumption must be toward non-coverage.

This is only an extension of the present approach, essentially founded on regulatory benefit/cost calculations, under which the Government has taken the view that manufacturing facilities are to be excluded from the ambit of the access regulations. This is an arbitrary delineation based on judgements about the risk involved versus the costs imposed. It is not necessarily invalidated by the fact that it inevitably gives rise to anomalies, for example the Hammersley/Robe River litigation over access to what the former successfully argued was a rail line that actually performed the function of a manufacturing facility.

By arguing for the exclusion of certain facilities we have taken the view that the additional regulatory costs likely to be imposed by a farther-reaching tool like access regulation are great enough to offset the risk that the alternative regulatory mechanisms available for use will prove to be less than wholly effective. That is, the access dimension of regulations does not offer sufficient additional ammunition to be justified. Similar considerations are behind the Hilmer disposition to exclude non-integrated facilites from within the purview of access regulation. This perspective should predominate over one based on the appearance of “inconsistency” at a formal level.

Hence, inconsistency of treatment for the businesses in those industries would not be an issue. In the case of electricity and gas, there is now no substantial supply in Australia that is vertically integrated in the way most were at the time of Hilmer. There are now separate structural arrangements (or their ring-fenced equivalent) for production, transmission, distribution and retailing in these industries at least outside Western Australia.

A second possible view of the inconsistency issue relates not to coverage *per se*, but to the pricing issue. It is common ground among all parties that non-integrated bottleneck facilities (other than entrepreneurial facilities) would need to be subjected to some prices surveillance mechanism in order to address the incentives of facility owners to adopt monopolistic pricing policies. Given this, it is reasonable to argue that inconsistencies of treatment could arise between pricing regulation applied to non-integrated facilities under prices surveillance mechanisms and that applied to integrated facilities under access pricing arrangements.

In practice, it can be expected that the respective regulators would be expected to be cognisant of this issue and of the nature and direction of decision-making under the alternative price regulation mechanism[9]. Concern to avoid charges of inequitable treatment, as well as the desire to avoid creating market distortions, would tend to lead to convergence of approaches and outcomes, within the limits that might be imposed by statutory and other guidelines. Thus, the size of any inconsistencies might be self-limiting to large extent.

Additionally, the extent of any inconsistencies in this regard could also be addressed directly through changes to the two price regulation mechanisms, that sought explicitly to ensure consistency. The adoption of explicit pricing principles within the access regime has been widely canvassed and would clearly represent a move in this direction. It is certainly possible to envisage complementary changes in prices surveillance legislation.

The extent of this form of inconsistency of treatment must also be considered in a broader perspective. As noted in the submission to the inquiry from the Law Council of Australia, the current proliferation of different access regimes has meant that widely differing approaches can be taken to different groups of facility owners, with considerable potential for inconsistent treatment[10]. Such inconsistencies are likely to be at least as great as those that would arise from the application of different prices surveillance mechanisms, and yet the continued enactment of new specific access regimes means that their number – and the scope for this form of inconsistency – continue to grow.

In sum, we would argue that any inconsistency of treatment arising as a result of the exclusion of non-integrated facilities would be relatively minor and capable of being addressed effectively through complementary changes to the relevant regulatory structures. Of itself, it would not constitute a compelling argument against the pursuit of the potential benefits of narrowing the application of access regulation and its attendant incursions on private property rights.

[9] That is, decision-makers regulating access prices under prices surveillance legislation would have regard to the approaches taken by decision-makers regulating access prices under access regimes, and vice versa.

[10] The question of different access regimes is discussed later in this submission.

2.2. Incentives may be created for facilities to separate vertically to avoid coverage

The possibility of significant incentives for separation of facilities to avoid coverage clearly can exist only to the extent that access regulation constitutes a major burden to facility owners. As the NCC notes in its submission (p. 43), embarking on a process of vertical separation of an integrated facility would entail both the "one-off" costs of separating the businesses involved and a potential loss of economies of scope. What are the possibilities that a facility owner would find it in their interests to incur such costs?

In circumstances in which economies of scope are significant, a facility owner would need to conclude that the gains due to escaping coverage were sufficient to counteract the loss of these economies. This will only be likely where the effective cost of the access regime is large. Moreover, moving to vertically separate the facility would not be likely to free it from price regulation, being likely instead merely to move the locus of that regulation to the prices surveillance legislation. Thus, the benefits sought would have to be found in escaping from the access regime, narrowly considered, plus any benefits from moving from one price regulation mechanism to another.

It is conceivable that there would be pricing related benefits from moving toward non-Part IIIA based pricing regulation. However, these benefits would be largely attenuated to the extent that reforms of both the alternative price regulation and Part IIIA were implemented to create a more uniform approach, as suggested in the previous section.

In sum, it must be considered unlikely that the prospect of escaping access coverage would be sufficient to encourage vertical separation in the presence of significant economies of scope.

By contrast, such incentives would seem much more likely in the absence of significant economies of scope. In these circumstances, the benefits of avoiding coverage would need only to be large enough to offset the one-off costs of separation. There may be numerous circumstances in which this would occur. However, it is difficult to conclude that such change would represent an outcome to be avoided. The Hilmer Report was clearly of the view that structural separation would, in general, comprise the "first best" means of ensuring effective competition in downstream markets. Access regulation, by contrast, was seen, essentially, as a "second best" solution to be applied where structural separation had not occurred.

Experience has however shown "ring-fenced" facilities to offer no less favourable treatment of non-affiliates than structurally separated facilities.

Structural reform in Australia, as elsewhere, has included acceptance of financial "ring-fencing" as an alternative to strict structural separation for a wide range of assets. It is our belief that experience with this approach has not indicated any major concerns with its adequacy in practice. This is perhaps due to the incentive that the competitors of downstream elements of such “ring-fenced” assets have every interest in bringing any discriminatory practices or failure to adopt arms-length transactions to the attention of regulatory authorities. The lack of any significant such cases can therefore be seen as sound evidence for the effectiveness of current ring-fencing arrangements.

Therefore, to the extent that such facilities are legally required to operate as independent businesses and are apparently doing so in practice, we do not believe there is any justification for treating them differently from other “non-integrated” facilities. It therefore follows that an argument in favour of excluding non-integrated facilities from Part IIIA would also imply exclusion of “ring-fenced” facilities.

Indeed, the synergies from integration of retailing and distribution differ markedly on a company by company basis. Without any compulsion, the South Australian and two of the Victorian electricity distribution businesses have elected to divest their retail business. Judgements on whether to remain integrated, given the ring-fencing that is in place, should be left to commercial considerations. As the existing regulatory arrangements that permit ring-fencing without structural separation have performed well, there is no need to disturb them and cause unnecessary costs.

2.3. Control over “transitional” situations would be weakened.

This aspect of the Commission’s view is expounded in particular in Chapter 3 of the Position Paper. In essence, it is concerned with publicly owned facilities that have been structurally separated in formal terms, but may not operate, in effect, at arms length from one another. The Commission, citing the Law Council of Australia submission, puts forward two reasons why this situation may arise:

- The long-entrenched culture of former State-owned natural monopolists; and
- A lack of incentives for these firms to achieve commercial returns.

In considering what weight to place on these factors, the range of possible alternative means of addressing them should be borne in mind. In relation to entrenched corporate cultures, this would appear to be a problem primarily of corporate governance. To the extent that any denial of access is not profit maximising, as suggested in the Law Council submission, the owners of the facility clearly have an incentive to install more accountable management.

There is no reason to suppose that governments, in their role as facility owners, would fail to be cognisant of this issue. Indeed, experience suggests that the process of “corporatisation” of state owned enterprises has, in most cases, led to substantial changes in corporate culture and in behaviours in the marketplace. It has most often been associated with thoroughgoing overhauls of management structures and personnel and with the implementation of clear performance targets and requirements. The suggestion that "long entrenched corporate cultures" are likely to be retained in this context appears, at the least, questionable.

Moreover, the Commission suggests[11] that the problem may be that of ensuring:

> *"…that such separation was not undermined by contractual reintegration through exclusive dealing with favoured suppliers in the downstream market."*

To the extent that the "exclusive dealing" noted here is consistent with any of the definitions contained in Section 47 of the Trade Practices Act, there is clearly another mechanism which could be relied upon to constrain such behaviour.

The second concern identified above is that of whether there are sufficient incentives for such firms to achieve commercial returns. The ability (as opposed to the incentive) to engage in non-profit maximising behaviour will clearly arise from a lack of rate-of-return disciplines.

While it is generally considered, *a priori*, that government owned enterprises face lesser incentives to achieve commercial rates of return than private companies, a number of factors suggest that such incentives will remain quite strong in relation to bottleneck facilities, notwithstanding the lack of direct market disciplines.

Firstly, the current political context is one in which governments that have chosen to retain assets in public ownership are invariably called upon to justify this decision. This is particularly the case in relation to assets of a type that other State or Territory governments have chosen to privatise. Within this context, the ability to point to strong rates of return is clearly fundamental, both as an indication that assets are being well-managed within the public portfolio and, as a corollary, as a means of identifying tangible benefits to taxpayers from the retention of the assets.

These imperatives suggest that governments will have little tolerance for management that fails to generate commercial rates of return on the public sector assets for which they are responsible. Evidence of this contention can be found in the fact that some governments (e.g. Victoria's) have, for some years, published target, or required, rates of return on public sector assets, as part of the budget process, or elsewhere.

A related point is that governments are increasingly focused on "fiscal consolidation" and, as a result, are unlikely to tolerate a situation in which opportunities to improve the budget position are lost due to the under-performance of public businesses.

A third important source of pressure on managers of public sector assets to earn commercial rates of return can be found in the National Competition Policy itself. A fundamental element of the policy, contained in Clause 3 of the Competition

[11] Position Paper, p107.

Principles Agreement, is the adoption of the principle of competitive neutrality. Clause 3 states that:

> *"The objective of competitive neutrality policy is the elimination of distortions in resource allocation arising out of the public ownership of entities engaged in significant business activities. Government businesses should not enjoy any net competitive advantage simply as a result of their public ownership."*

Consistent with the focus on eliminating distortions in resource allocation, the application of competitive neutrality policy has been held to require that governments ensure that public business entities pay dividends equivalent to market rates of return on the assets they employ. The implementation of competitive neutrality has entailed the establishment of complaints mechanisms whereby affected businesses can seek to ensure that the policy is fully applied. Thus, to the extent that publicly owned firms consistently earn low rates of return, there is a high probability that competing businesses would seek, in their own self-interest, to have the matter considered in terms of competitive neutrality policy.

It is apparent that these mechanism are less direct in their application than the market disciplines applicable to listed public companies. However, it is contended that they remain substantial enough to raise a question as to whether there is a significant argument to justify access regulation as a means of constraining publicly owned firms to behave commercially.

2.4. Evasion by facility owners structuring their affairs to "walk the line" on separation would occur, leading to ongoing monitoring and enforcement problems

The National Competition Council argues in its submission that the question of whether a facility is integrated or not is clearly not a "binary variable". It considers there to be a range of different ownership structures, leading to difficulties of definition as to what would be regarded as an "integrated" facility, were this to become a test of the application of an access regime. Within this context, the NCC takes the view that facility owners would seek to structure their affairs to achieve the benefits of integration while avoiding coverage under an access regime.

The NCC used these premises to justify regulation in the Eastern Gas case. The Australian Competition Tribunal has found the case it made to be mistaken. The NCC argued strongly to this Inquiry for a comprehensive coverage of bottleneck facilities on the basis that such coverage imposes little cost. The Council was not always so sanguine about the costs of declaration. Indeed, its August 1996 publication on the matter[12], it said

[12] NCC, The National Access Regime, Draft Guide to Part IIIA of the Trade Practices Act, Aug. 1996.

> *"Provided the business which owns or operates the infrastructure does* <u>*not*</u> *also compete in upstream or down-stream markets, the public policy issue is basically one of dealing with monopoly prices."* (P. 6).

While noting the benefits of access regimes in encouraging more upstream and downstream competition, the Council was mindful of the costs of such a regime, noting,

> *"First it may diminish incentives for businesses to invest in infrastructure facilities and thus limit, rather than enhance, overall competition and economic efficiency. Second, compelling infrastructure owners to provide access to others necessarily can impinge on private property rights. Third, legislated access regimes are but one of several regulatory mechanisms available for countering market power. The choice of regulatory tool needs to be aligned properly with the source of the market power problem."* (P. 7)

There may well be doubt at the margin as to whether certain kinds of relationships would be judged as constituting an "integrated" facility. The size of this problem is less clear[13]. The additional task faced by a regulator requested to "declare" a facility should be considered in the context of those tests already required to be undertaken. Under Section 44(G)2 of the Trade Practices Act, in determining whether a facility should be declared, the NCC is required to satisfy itself on the following matters:

- that access (or increased access) to the service would promote competition in at least one market (whether or not in Australia), other than the market for the service;
- that it would be uneconomical for anyone to develop another facility to provide the service;
- that the facility is of national significance, having regard to:

  (i) the size of the facility; or
  (ii) the importance of the facility to constitutional trade or commerce; or
  (iii) the importance of the facility to the national economy;
- that access to the service can be provided without undue risk to human health or safety;
- that access to the service is not already the subject of an effective access regime;
- that access (or increased access) to the service would not be contrary to the public interest.

[13] The preceding sections of this submission have commented on this matter, questioning the extent to which minority stakes in downstream producers can reasonably be considered to constitute "integration" or "effective control", given the constraints of the market and of corporations law. This is not to dismiss the NCC argument in this respect. A relatively skeptical view is, however, justified in considering whether various related company arrangements could be judged as constituting "integration".

Hence, while the task of reaching a judgement as to whether a facility is integrated may not be trivial, it would be taken in the context of the regulator's need to reach judgements on a large number of related, substantive matters. Such an additional requirement is not a disproportionate additional burden on the regulator. It would seem to be overshadowed by the corresponding benefit of restricting the scope of access regulation to the minimum necessary, as recommended by Hilmer.

Secondly, it is clear that the problems involved would be, to a substantial degree, transitional ones. As at present, the regulator (currently the NCC) would no doubt strive to achieve certainty and predictability, thereby minimising regulatory costs to the parties, by ensuring consistency in its approaches to the question of integration. As a result, an accumulating body of "precedent" as to what structures were and were not deemed to constitute integration would be assembled. This would mean that the costs of this additional requirement, to both the regulator and facility owners, could be expected to diminish over time.

2.5. Behaviour that is socially costly would escape from "the main remedy available in the Australian competition policy regime", while no social benefits can be identified from this outcome.

The Commission quotes this line of argument from the National Competition Council's submission[14]. The NCC argument is essentially twofold. Firstly, a non-integrated facility owner will have an incentive to deal exclusively with the most efficient downstream provider and, through the adoption of a two part tariff, to appropriate all of the rents available in the downstream market. In such a case, the outcome mimics that of the integrated facility owner. Secondly, even were a two part tariff ruled out, the facility owner will charge an input price that does not attain efficient output.

These arguments appear to assume that the alternative to coverage under an access regime for non-integrated facilities would be to leave such facilities totally unregulated. Leaving aside entrepreneurial facilities which have not benefited from government assistance, this option is not contemplated by this submission or by other submissions to the Commission that have proposed excluding unintegrated facilities from access regimes. Indeed, the NCC seems implicitly to acknowledge the point that an arrangement in which a facility owner dealt exclusively with the most efficient downstream provider and charged a two part tariff that appropriated all available rents would be almost certain to be captured by the anti-competitive conduct provisions of Part IV of the Trade Practices Act.

To the extent this is so, the question becomes one of monopoly pricing, as noted in the Freight Australia submission[15],

[14] Submission No 43, pp23-25.
[15] Submission No. 19, p6.

> *"Where the owner of an essential facility does not compete in a related market, the owner has an incentive to maximise the competitiveness of the related market in order to maximise the monopoly rents that could be earned from the facility. That said, the owner may still use its strategic position in the market to charge monopoly prices, restrict throughput and earn further rents. The problem of access regulation in this situation, as identified in the Hilmer Report, is strictly a problem of pure monopoly pricing. As such, prices monitoring or surveillance would be sufficient to remedy the problem."*

Thus, the two scenarios advanced by the NCC are adequately addressed by the combination of Part IV of the Trade Practices Act and the Prices Surveillance Act, or a successor prices surveillance mechanism. Such an approach is consistent with the principle of "minimum necessary regulation"[16] and, more specifically, with the Hilmer Report's view that access regimes should be applied as narrowly as possible, given the interference with private property rights that is implicit in them[17].

By contrast, it is not clear that such an approach would allow "…escape from the main remedy available in the Australian competition policy regime…". It does not appear tenable to suggest that access regulation either does or should constitute the "main remedy" in the Australian competition policy regime. The social benefits that would follow from the exclusion of non-integrated facilities from access coverage are discussed earlier in this submission, as well as being canvassed in a large number of other submissions to the Commission. In brief, they embrace both the general interest in limiting governments' interference in private property rights and the specific dynamic efficiency benefits of reducing the size of the disincentives to efficient infrastructure investment resulting from access regulation.

We consider increased regulatory costs are likely to result when a firm is regulated under two separate provisions. Dr Tamblyn, the Victorian Regulator-General recently emphasized[18] that regulators are not "at large". They need to operate within the confines of their legislation, which does not permit them to seek out situations to regulate *just in case.* Nor should sound regulation provide *belt-and-braces security*. Offering regulatory agencies powers that are broad-ranging provides avenues to extend the regulatory oversight beyond the ambit intended by Parliament. It is in such matters that regulations can severely impede efficient operations and investment.

3. Benefits of adopting a more narrowly focused regime

[16] This principle is widely held, in recognition of the potential for unanticipated effects of regulation, as well as its tendency to lead to dynamic inefficiency. See, for example *Recommendation of the Council of the OECD on Improving the Quality of Government Regulation* (1995), *A Guide To Regulation (2nd Ed.)*(Office of Regulation Reform, Productivity Commission) and *Principles and Guidelines for National Standard Setting and Regulatory Action by Ministerial Councils and Standard-Setting Bodies* (Council of Australian Governments, 1995, 1997).

[17] "…this fundamental principle, based on notions of private property and freedom to contract…(is) not one to be disturbed lightly". Hilmer Report, p242.

[18] Address to the IBC Conference *Energy Regulation*, Melbourne, April 30 2001

of access regulation

The above discussion has focused on the Productivity Commission's stated reasons for concluding in its position paper that the *status quo* should be maintained in respect of the application of access regulation to non-integrated facilities. It has, in general, argued that the costs of excluding these facilities from coverage, identified by the Commission, are in many cases likely to be either small or illusory. In so doing, it has referred at several points to the potential benefits of such a limitation of the scope of access regulation. This section focuses on these potential benefits of favouring a strictly limited application of access regulation and argues that they are likely to be considerable.

3.1. Impacts on investment

The question of the impact of access regulation on investment has been widely discussed in the context of the current inquiry. This discussion has included both theoretical considerations and attempts to analyse the impacts of the specific forms of access regulation currently implemented in Australia.

3.1.1 Theoretical issues

The potential for access regulation to have a "chilling" effect on investment almost certainly represents the major cost likely to be associated with it. It is, by definition, not possible to observe investment that has not been undertaken as a result of regulatory disincentives. However, the potential for regulation to lead to major dynamic inefficiencies due to distortions of investment behaviour is apparent. As the submission of Santos Ltd stated:

> *"It is difficult, however, to argue that something which reduces an investor's returns is not something of a disincentive to invest."*

As argued above, disincentives to investment arise both from specific concerns as to the risks to returns from particular assets due to the operation of a given access regime and from a general tendency for greater "sovereign risk" to be imputed where governments are seen as overly willing to constrain private property rights.

A risk averse view is clearly required in such circumstances. This follows from the arguments made above that the overall importance of dynamic efficiency issues is likely to outweigh that of static ones and that much of the impact of access regulation is likely to be to effect transfers, rather than to increase efficiency. Thus, consistent with the view advanced by Hilmer, we believe the evidence for the disincentives effects of current access regulation arrangements on investment presented to the Commission supports the need for a cautious and minimalist approach to the application of access regulation.

In this context, the submission of the Law and Economics Consulting Group, for Freight Australia, should be noted. It argues that regulators should generally choose to avoid "Type 1" errors in decision-making, at the expense of making "Type 2" errors more likely. That is, one should err on the side of failing to declare essential facilities, rather than on the side of declaring non-essential facilities. This is because other remedies, both in competition legislation and in other areas, are available to address type 2 errors. By contrast, there are no immediate remedies identifiable to address type 1 errors[19].

In addition, we note the analysis of *ex ante* and *ex post* rates of return provided in King's submission[20], which argues that the application of access regulation can have the effect of reducing *ex ante* returns (i.e. expected values) below the level necessary to bring forth some investments, to the extent that it operates to remove economic profits from investors in bottleneck facilities. This effect is marked where significant uncertainties attach to likely returns from the proposed investment, suggesting that the disincentive to investment that would result would be most important where possible new infrastructure investment (cf the renewal or expansion of existing assets) was contemplated.

We believe this argument has considerable force, in particular when considered in relation to the issue of the extensive information required to underpin effective and efficient price regulation, which has been raised in numerous submissions to the current inquiry. The Freight Australia submission noted that pricing principles, where specified in existing access regulation, are often poorly chosen, being based on pragmatic, rather than efficiency considerations. The submission argues:

> "*Regulators should be mindful of the limitations and potential adverse effects that flow from a pragmatic, but poor, choice of pricing principles. Pricing principles that dampen investor incentives or undermine investor confidence would detract from the efficiency objective of access regulation"*[21].

The submission of Energex similarly argued regulators have tended to follow poor pricing rules and that, for this reason, an approach based on the use of Section 46 of the Trade Practices Act may often yield superior results.

The choice of "pragmatic" pricing principles in practice is likely, in most cases, to be the result of recognition of the difficulty of obtaining the information required to implement "efficient" price regulation. To the extent that this is true, the adoption of a "risk averse" approach, involving erring toward leaving monopoly rents uncaptured, is a necessary outcome. Gans and King argue that:

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[19] See Submission No.19: Freight Australia/Law and Economics Consulting Group, p13.
[20] See Submission No. 1: *Access: what, where and how?* Steven I. King, University of Melbourne, pp 12-14.
[21] See Submission No. 19: *op cit., p 2*.

> *"…the regulator will have to consider itself as leaving some monopoly rents with regulated service providers. In this regard, the rents are simply an incentive bonus…and not monopoly profits per se.*[22]*"*

Given the degree of imprecision involved, due to informational requirements, and the relatively "light handed" approach that appears to be indicated as a result, it is not clear that price regulation under an access regime would exhibit superior performance in practice to one based on prices surveillance legislation. Thus, any justification for extending the application of access regulation based on its superior performance in relation to monopoly pricing *per se* may be questionable. This, in turn, tends to support the adoption of a narrow view of the applicability of access regulation.

3.1.2 Current access regulation

Consideration of the evidence on the current operation of access regulation in Australia is clearly important in weighing the theoretical arguments, as well as informing any judgements as to whether the specific form of access regulation that has been adopted is consistent with regulatory "best practice".

Firstly, as noted above, a number of submissions have argued that regulators have adopted "pragmatic" rather than "efficient" pricing principles in practice, and that this necessarily reduces the likelihood that the theoretical benefits of price regulation will be attained.

Secondly, it is common ground that considerable uncertainty surrounds the question of whether, and to what extent, investments have been delayed, distorted or cancelled due to access regulation, with data being scarce and inadequate. However, submissions have included both attempts to provide broad measures and more specific, or anecdotal, evidence. The submission of the ACCC is prominent in the former category. It is notable that the Commission itself, in its Position Paper has explicitly rejected the ACCC views that current comparative rates of return, together with the evidence of new investment plans in some regulated sectors, can be taken as strong evidence that access regime has been benign in relation to investment[23].

In this context, evidence regarding the impacts of access regulation on specific investment proposals must clearly be given weight. The Commission's Position Paper cites a number of cases brought to its attention in the submissions, all but one of which suggest that access regulation has had disincentive effects. While the "sample" of project specific information is small in size, it is notable that a preponderance of the cases cited argued that access regulation was a disincentive to investment. Indeed,

[22] Economic Choices Associated with the Proposed Essential Services Commission. Joshua Gans & Steven King, p21. Submitted by the Australian Council for Infrastructure Development (Submission No.11).
[23] See Review of the National Access Regime: Position Paper. Productivity Commission, March 2001, p65.

BHP was alone in arguing that an access regime had, in its case, facilitated a new infrastructure investment[24].

One particular instance that has come to our notice concerns TXU Networks, which sought a variation of its access arrangement to allow the profitable reticulation of gas into Barwon Heads in Victoria. This expenditure was not originally forecast and hence required the ORG's authorisation. The company sought a return on capital expenditure at the same rate as that on all TXU capital expenditure. The variation was rejected by the ORG and TXU deferred the investment to supply gas to the area.

Also of note in this context is the Melbourne Airport case, in which the ACCC sought to intervene in a case in which a voluntary agreement had already been reached between the facility owner and the access seeker. In this case Melbourne Airport and Impulse Airlines had agreed on terms for access by the latter to the new Domestic Express Terminal. In its submission to the Commission, Australia Pacific Airports Corporation argued that:

> *"Ideally, users and providers should be able to agree on terms and conditions of supply free from intervention by the regulator. This not only ensures that operators are receiving an adequate return, but it properly reflects on the value that users place on services provided."*[25]

The APAC submission argues that, by contrast, when regulators consider pricing mechanisms "the sole focus of attention is the provider of the service". As a result:

> *"…the apparent willingness to pay of a customer was not even mentioned in the ACCC's draft decision."*

Moreover, it is argued that, *despite the voluntary arrangement between the parties ultimately surviving* the regulatory intervention by ACCC, there has been a tangible result in terms of investment disincentives. According to APAC:

> *"…as a result of the ACCC's conduct, the Board of APAC will now no longer approve investment in new aeronautical facilities until such time as a final pricing decision is available."*

These considerations of private property rights and outcomes in terms of business decisions strongly suggest that a regulator should avoid intervening in voluntary arrangements between two private agents.

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[24] It should be noted that BHP's statement is no stronger than that its investment was "directly facilitated by the [Gas] Code". It does not state that the investment would not have proceeded in the Code's absence, whereas the cases cited to the contrary have explicitly stated that certain investment proposals have been abandoned as a direct result of access regulation considerations.

[25] Australia Pacific Airports Corporation, Submission No.10, December 2000, p 5.

4. Improving access regulation

In general, the scope of access regulation should be narrowed as far as possible, consistent with its underlying purposes. This is essential due to the general requirement in a liberal society for government to minimise its interference in private property rights and the more specific need to ensure that dynamic inefficiencies arising from the distortion of private investment incentives are minimised. In particular, it is argued that access regulation should be:

- Limited in its application to vertically integrated facilities;
- Limited to cases in which the provision of access is necessary to create the conditions for workable competition in downstream markets[26];
- Limited to cases in which the duplication of facilities is clearly not economically feasible;
- Not applied to infrastructure developed without the benefit of a government franchise or any other support.

In general, then, we follow a large number of other submissions to this inquiry in arguing that access regulation rules should be much closer to those envisaged by the Hilmer Report than is presently the case.

Whether or not the scope of access regulation is narrowed along these lines, we believe that the form of access regulation should also be improved. The key purpose of reform in this regard is to reduce the extent of the negative impacts of access regulation on incentives and on perceptions of regulatory risk. If the scope of access regulation retains its current breadth, as opposed to being narrowed as urged by others, and ourselves, the importance of these reforms to reduce its impact will be concomitantly greater.

4.1. Consistency between access regimes

We support the arguments contained in the submission of the Law Council of Australia, to the effect that the form of access regulation–where such regulation is applicable–should be made consistent, as far as possible, across all sectors. Thus, Part IIIA should form the basis for all access regulation, with industry specific access regimes being approved only where there are substantial industry-specific issues to be addressed. All industry-specific regimes should be made fully consistent with the general principles embodied in Part IIIA.

[26] We note that the Commission has indicated a similar view via the inclusion of Proposal 6.1. in its Position Paper. However, focus on ensuring a "substantial increase" in competition would derive from access regulation arguably would continue to fall short of the Hilmer formulation of access being provided where necessary to ensure "effective competition".

In particular, industry specific access regulation should not substitute lower "thresholds" for applicability than those applied in Part IIIA. In this context, we note as an example the submission of Australia Pacific Airports Corporation. This argues that, by declaring certain facilities to be subject to Part IIIA, the Airports Act has the effect of lowering the threshold for its application, in particular in terms of the "national significance" aspect of the criteria for application.

The mechanism of "declaring" that an access regime applies to particular facilities clearly precludes the operation of the generic processes by which the NCC informs itself of the views of the parties and reaches a considered view as to whether the criteria for application have been met. In so doing, it inevitably undermines the notion that access regulation is an unusual intrusion on property rights, which is to be used sparingly, as originally argued by Hilmer.

Finally, there is merit in the Law Council's view that each industry-specific access regime should be subject to regular review to ensure its continuing need and that its form remains appropriate to the industry and the markets it faces. This view is consistent with the general view that regular regulatory review is essential to ensure the maintenance of regulatory best practices in a dynamic sense. More specifically, however, it is clear that many of the industries that are subject to access regulation will be characterised by rapid structural and technological change in the medium term. This suggests both that the need for access regulation *per se* may change over time and that the requirements of industry specific access regimes may also be subject to major change.

The frequency of such reviews may vary between different industry access regimes, reflecting different expectations about the rate of change. This has tended to increase. Existing "sunsetting" and mandated review requirements for legislation in Australia tend to work on five to ten yearly cycles which suggests that a five yearly review period should form the starting point for consideration in relation to individual industry access regimes.

As important as the frequency of such reviews is the nature of the review process itself. A fundamental consideration is that reviews must be conducted independently of the industry access regulator. They should be conducted transparently, by a body with adequate expertise, such as the Productivity Commission.

Given these views, we support the direction of Finding 4.2. of the Commission's Discussion Paper, but believe that additional recommendations, as per the above, are required.

4.2. Inclusion of pricing principles

As noted above, we believe that there is, in general, considerable scope for pricing principles to be undermined in practice by the regulator, via the exercise of his necessary discretion. Consequently, pricing principles must be detailed and carefully specified if they are to be able to improve regulatory outcomes and enhance accountability on the part of the regulator, by providing an improved basis for the challenge of decisions by the regulated.

Therefore, we welcome the proposal made in the Commission's Position Paper that pricing principles should be inserted into Part IIIA. We believe that the specific pricing principles proposed by the Commission in Proposal 8.1. (Tier 1) are broadly appropriate for this purpose but are not, in themselves, sufficient. The principles as stated do not acknowledge two fundamental issues of price regulation. The first is the need for the evolution of such regulation over time to be consistent with the provision of incentives for continuously seeking improved productivity and efficiency performance. In order to deal appropriately with this issue, the following considerations must also be embodied in pricing principles:

- Pricing regulation should be "light handed" in its approach, both in terms of the extent of its attempts to capture monopoly profits and the information requirements imposed on the regulated;
- In pursuit of the above, it must be accepted that there should be some sharing of productivity gains between producers and consumers[27];
- There should be recognition that, in a competitive market characterised by high entry costs and high levels of specific expertise, "super-normal" profits can persist for some time and are likely to be necessary to provide adequate signals for the entry of new competitors;
- Use of CPI-X regulation, to be fully incentive compatible, should incorporate price resets calculated on the basis of reference to industry TFP, rather than rates of return or cost-based building blocks.

We note, in the above context, that the need for price regulation to be incentive compatible over time is acknowledged in the Commission's Proposal 8.2. *We particularly urge the Commission to adopt a robust version of this "Tier 2" proposal in its final report.* Such a variant of this proposal might require explicit justification of any use of cost-based methodologies by the regulator, beyond the initial price-setting exercise, and might also suggest the forms that such a justification would be required to take.

A second issue that requires reflection in pricing principles and is not currently covered by the Commission's Proposal 8.1. is the need for an approach that is "conservative", in the sense of erring toward allowing facility owners to retain

[27] In this context, the Victorian Office of the Regulator-General's current uses an "efficiency carryover" model, which allows regulated entities to obtain benefits from past efficiency gains over a five year time horizon. It is however unclear why the ORG's 70/30 sharing between customers and companies is superior to a more "natural" 50/50 sharing.

monopoly profits, rather than toward risking “under-compensation”. The point to be underlined is that a conservative approach is required, not only to ensure investment incentives are maintained, in the positive sense, but to ensure “in the negative” that facility owners do not receive sub-normal, or even negative, returns as a result of failed attempts at a too “surgical” approach to price regulation.

This point is essential given the widely acknowledged problem of price regulation being information intensive and, as a result, subject to a relatively high degree of error. We note that the Commission’s Position Paper acknowledges this view, notably at p207, where similar views provided in submissions from NCC and IPART are also cited, and at p71. However, the view is not reflected in the recommended pricing principles.

4.3. Provision for “access holidays”

Access regulation can have significant disincentive effects on new investments in infrastructure through its impact in reducing *ex ante* expected rates of return. This effect is clearly most pronounced where the construction of new facilities is being considered, as the degree of uncertainty as to the returns to the project will generally be greatest in these cases.

Following from the discussion of property rights contained in the first part of this submission, we have argued that access regulation should not apply to infrastructure that is developed without the benefit of a government franchise, or other government support. In the current Australian environment, the adoption of this approach would be likely, in effect, to exempt most new infrastructure investment from coverage by access regulation[28]. Non-coverage of entrepreneurial facilities would mean the need for other means of ameliorating the problem of investment incentives, such as “access holidays”, would be much reduced.

In the absence of a narrowing of access coverage, an essential “second best” amendment would be that access regulation be reformed to provide explicitly for the use of “access holidays” in relation to new infrastructure projects. This may well have been a suitable means of ensuring early development of the extension of gas to Barwon Heads in the TXU Networks case discussed in section 3.1.2. This position would also be consistent with that provided to inventions and works of art and is a view well received in the Commission’s Position Paper (pp189-190), where the Commission argues that *“In many respects, an access holiday would be akin to a patent.”*. However the Commission made no specific recommendations on this issue.

Equating and access holiday to a patent appears to be a useful view of the concept of

[28] Arguably, for those new investments that are given a franchise or other effective subsidies, concurrent agreement on access issues would ensure that appropriate incentives could be maintained. However, there may be difficulties under current access regime arrangements due to the difficulty in concluding such an *ex ante* set of access arrangements.

access holidays, insofar as it suggests that the access holiday constitutes an explicit recognition of the right of the facility provider to the return on his investment as the *quid pro quo* for his creation of new value. It could also be married with the traditional common law concept of bottleneck facilities being "affected by the public interest", whether or not they were developed under a franchise.

The important point is that the access holiday does not, properly considered, represent a "concession" by the regulator. Rather it is, at least insofar as facilities are developed with no or minimal government assistance, a recognition of the facility-owner's property rights.

Consistent with this reasoning, the Commission's proposed mechanism for implementing access holidays – that of "null undertakings" may not be optimal. The undertaking mechanism functions as one in which facility owners "voluntarily" cede access to their property on certain terms, under threat that arbitration by the regulator may yield less advantageous terms. It was not envisaged as a means by which property rights may be positively affirmed. Moreover, as the Commission's discussion suggests (p189) use of the undertaking mechanism may create a presumption – or some pressure, at least – toward the specification of "post holiday" access terms as part of the "null undertaking". This would clearly be inappropriate, given the need for consideration of such matters to be made *ex post* in order to be cognisant of the history of the facility and the returns made on it.

There is also that there is some doubt as to whether Part IIIA, as currently drafted, allows for the use of "null undertakings". Amendments that would make explicit provision for access holidays would clearly be needed. In this context, it seems preferable to establish such provision separately from the existing undertakings provisions, given the different fundamental purposes served. Alternatively, it is arguable that provision of an access holiday is more closely equivalent to a "negative declaration", with the distinction (vis-à-vis existing declaration arrangements) that it would occur *ex ante.*

More important than the specific mechanism by which access holidays would be conferred is the question of the terms of the access holiday. The broad terms of access holidays must be explicitly set out in legislation if the desired effect, of minimising regulatory uncertainty and disincentives, is to be attained. This does not, however, prevent the inclusion of some element of flexibility to deal with different circumstances.

We believe that the proposals contained at page 193 of the Commission's Position Paper are broadly appropriate, but propose the following amendments:

- Provision for variation of the standard period of the access holiday should be symmetrical: that is, it should also be open to the investor to propose that a longer than standard period is required due to the specific characteristics of the project;

- Any ability for the regulator to reject the holiday on the basis of the likely *ex ante* appearance of high profitability should be closely circumscribed, with a high standard of proof of both high profitability and relatively low risk (or uncertainty) being required[29]; and
- Additional flexibility should be provided by enabling extensions or augmentations of existing facilities (or network related investments) to be subject to access holidays, but that such requests would be assessed without any presumption in favour of acceptance.

Recent comments from the ACCC indicate that they, too consider that the concept of access holidays may have merit.[30] In this context, we support the ACCC view that

> *"The Commission does not want this process to be seen as one of picking winners. By this we mean that it is one thing to grant a regulatory holiday for all entrepreneurial pipelines, but it is quite another for governments to pick and choose which projects are granted this status".*

However, we would question the ACCC's presentation of the question in terms of when market power would arise and be "able to be exercised", rather than in terms of the need to ensure that investment is not deterred by limitations on *ex ante* expected returns. The ACCC suggestion that, in contrast to the Commission's preference for a fixed duration of access holiday, there could be an *ex post* "deeming" that market power exists and the holiday is thus truncated would also have the potential to largely undermine the potential benefits of access holidays.

In sum, provision of access holidays would be a crucial "second best" mechanism for minimising investment disincentives, were the preferred option of exempting new investment that do not receive government assistance from coverage not to be accepted. The Commission's proposal that such holidays should be approved in a "quasi-automatic" fashion is fundamental to the achievement of the goal of access holidays. The use of a strong presumption in favour of a pre-set holiday period (say ten or perhaps twenty years) is equally important.

5. Necessary improvements to related regulation

Some aspects of this submission's contention that access regulation should be narrowly applied are predicated on the view that alternative regulatory instruments are available to deal with some issues and that, being less intrusive than access regulation, they should be preferred wherever they are likely to be effective. This applies particularly in relation to the regulation of non-integrated bottleneck facilities, where

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[29] This view is consistent with the Commission's own argument (p193) that "…the fact that a project may turn out to be highly profitable should not be of great concern. …at the end of the day, if infrastructure facilities are not built, consumers will be worse off.

[30] "What is the Regulatory Policy Agenda for 2001 and Beyond?" Speech by Mr Rod Shogren, Commissioner ACCC, 30 April 2001. See www.accc.gov.au

we have emphasised the distinction between incentives to deny access and incentives to adopt monopoly pricing.

A number of submissions have argued that alternative regulations that might be regarded as substitutable for access regulation in some areas are insufficient and/or are ill-adapted to these tasks. This is a view taken up to some degree in the Commission's Position Paper. In particular, the Commission has noted that:

- the Prices Surveillance Act contains no power to enforce particular price outcomes; and
- Part IV of the TPA might be ineffective in dealing with collusive practices of non-integrated facilities, due to the difficulty of establishing the intent behind the use of market power, as required by Section 46 (pp106-7).

It is fundamental that the possibility or desirability of reliance on these alternative regulatory mechanisms should not be considered from a purely static viewpoint. There may, indeed, be significant shortcomings in these instruments in terms of their ability to perform the functions of access regulation in relation to non-integrated facilities. However, the possibility of improving these instruments in such a way as to address these shortcomings also merits consideration.

It is preferable to consider the scope for amending and improving existing legislation if, by so doing, an adequate tool can be created which remains less intrusive and, thus, less subject to regulatory failure, than the alternative of a broader application of access regulation.

In generic terms, it may be appropriate to consider whether additional parts should be added to these instruments, which deal specifically and exclusively with bottleneck facilities. Some specific issues are considered below.

5.1. Possible amendments to the Prices Surveillance Act (PSA)

The Commission, in the draft report of its separate inquiry into the PSA, has recommended that the PSA should be repealed and replaced with modified inquiry and monitoring functions to be written into a new section of the Trade Practices Act. The adoption of this recommendation would, in our view, further strengthen the case for adopting a "prices surveillance" alternative as a means of enabling a narrowing of the ambit of access regulation. This is so to the extent that the integration of the two mechanisms within a single piece of legislation should maximise the possibilities of effective co-ordination between them and thus reduce the likelihood of "inconsistent" treatment of different types of facilities. In particular, the adoption of this recommendation would assist in ensuring any pricing principles adopted could be applied to all essential facilities, whether regulated under Part IIIA or elsewhere.

The Commission’s recommendations also include the establishment of a price control mechanism, to be used in cases of “substantial market power”, but only where it could be demonstrated that it to be superior to lighter handed instruments. The implementation of such a mechanism would seem substantially to address the fundamental criticism of the PSA’s potential use in relation to essential facilities; that is, that it does not provide for the regulator to enforce a particular price outcome.

We accept that, given the importance of the downstream linkages from bottleneck facilities and the approach to price regulation currently taken in respect of them, such a price setting power would need to form part of any modified prices surveillance mechanism, were it to be used in this context.

While the proposed price setting power may be generally applicable, it may still be necessary to create a separate “sub-Part” of the Act, the application of which was specific to downstream facilities. This would, in particular, need to include explicit pricing principles in order to minimise regulatory risk and uncertainty. Clearly, regard would need to be had to ensuring that such principles were, as far as appropriate, consistent with those adopted under a revised Part IIIA.

In sum, there appears to be no fundamental impediment to using the prices surveillance vehicle as a means of regulating non-integrated facilities and so narrowing the scope of access regulation. Given that substantial changes to prices surveillance legislation are currently contemplated, this would seem to be a particularly timely point at which to consider this alternative. Moreover, the proposed inclusion of a price control mechanism in revised prices surveillance legislation seems likely to overcome a major objection to this course raised by others in the context of the Commission’s current enquiry.

5.2. Changes to Part IV of the Trade Practices Act

Section 46 has been subject to many criticisms from those seeking to stiffen the restraints on business’s actions. It is difficult to handle the particular section since it makes illegal under certain circumstances the activities of a firm that seeks to eliminate or substantially damage a competitor. Yet, in many respects, this describes the cut and thrust of competitive activity. The Hilmer Committee examined the deficiencies of s 46 and concluded these deficiencies were real when applied to the integrated monopoly. Accordingly it sought to supplement these provisions only in the case of an integrated facility.

We have, in this submission, contended that the scope of Part IIIA should be narrowed, in recognition of the degree of intrusiveness of access regulation on private property rights. In this specific context, there may be room to consider whether amendments to Section 46 would better enable it to function as an alternative instrument in relation to facilities that would otherwise be likely to be subject to Part

IIIA. We do not seek to be prescriptive about the nature of any such changes. However, it is necessary to recognise that the possibility of remedying any perceived shortcomings of Section 46 in this regard may need to be entertained in order to arrive at the minimum necessary level of regulation in regard to certain facilities.

In sum, we believe it is essential that the Commission's final report should explicitly consider the option of amending alternative regulatory instruments in order to facilitate the possibility of restricting the scope of access regulation to the minimum possible extent. The adoption of a strictly static approach to these alternative mechanisms, as suggested by a number of submissions to the inquiry and, to some extent, in the Commission's Position Paper, would militate against the proper exploration of all avenues likely to lead to a "best practice" regulatory outcome.

APPENDIX

COST OF SERVICE REGULATION – ORG PAPERS

A. ELECTRICITY

1. Industry Structure And Regulatory Framework

- Office of the Regulator-General Act 1994
- Electricity Industry Act 1993, 2000
- National Electricity Code

2. Price Regulation

- Victorian Electricity Supply Industry Tariff Order

Electricity Distribution Price Review

- Final Determination 21 September 2000
- Draft Decision May 2000
- Submissions in response to Draft Decision – 65 submissions
- ORG Issues Paper
- Submissions in response to Issues Paper – 62 submissions
- Consultation Paper no. 5
- Submissions in response to Consultation Paper no. 5 – 6 submissions
- December 1999 Distribution Businesses' submissions to the ORG – 5 Submissions
- ORG Guidelines for the preparation of Price Review Submissions
- Consultation Paper no. 4
- Submissions in response to Consultation Paper no. 4 – 10 Submissions
- Consultation Paper no. 3
- Submissions in response to Consultation Paper no. 3 – 13 Submissions
- Consultation Paper no. 2
- Submissions in response to Consultation Paper no. 2 – 14 Submissions
- Finalising the framework
- Submissions in response to Finalising the Framework – 3 Submissions
- Consultation Paper no. 1
- Submissions in response to Consultation Paper no. 1 – 18 Submissions
- Base case levels of service quality
- Report prepared for Office of the Regulator-General and Service Standards Working Group on 13 August 1999 by PB Power, *Merz and McLellan Division* - Reliability Service Standards
- Report prepared for Office of the Regulator-General dated 14 July 1999 by PB Power, *Merz and McLellan Division* - Report on Voltage Standards
- Submission format, information templates and definitions
- Final Report on Costs Allocation prepared by KPMG Consulting for the Office of the Regulator-General dated 19 September 2000, Attachment -Summary Templates
- Safety Related Costs (post 17 May 2000 comments) prepared by Office of the Chief Electrical Inspector for the Office of the Regulator-General dated 21 August 2000
- Safety Related Costs Earth Testing - Powercor prepared by the Office of the Chief Electrical Inspector for the Office of the Regulator-General dated 7 September 2000
- Service Incentives prepared by PB Power for the Office of the Regulator-General dated August 2000
- Further Analysis of Distributor Capital Expenditure and Reliability of Supply prepared by PB Power for the Office of the Regulator-General dated September 2000

- Overview of Distributor Responses prepared by PB Power for the Office of the Regulator-General dated 5 September 2000
- Demand Forecasting - Final Report prepared by Sinclair Knight Merz for the Office of the Regulator-General dated September 2000
- AGL Electricity Limited - Costs of Full Retail Competition dated 1 September 2000
- CitiPower - PB Power's Report on the Costs Associated with Full Retail Contestability dated 1 September 2000
- Powercor Australia Ltd - Response by Powercor Australia to PB Power's Final Report dated 25 August 2000
- TXU - Comments on PB Power's Final Report on Costs of Full Retail Contestability
- United Energy Ltd - Electricity Distribution Price Review : Full Retail Contestability Study dated 24 August 2000
- Final Report on Costs Associated with Full Retail Contestability prepared by PB Power for the Office of the Regulator-General dated 25 August 2000
- Response to the Office of the Regulator-General prepared by the Environment Protection Authority - Polychlorinated Biphenyls Notifiable Chemical Order - Impacts on Electricity Distribution Costs dated 12 July 2000
- Preliminary Report on Costs Associated with Full Retail Competition prepared by PB Power for the Office of the Regulator-General dated 2 June 2000
- 2001 Electricity Distribution Price Review - Report to the Office of the Regulator-General on Income Tax Issues prepared by BDO Nelson Parkhill Services (Vic.) Pty Ltd dated 30 May 3000
- 2001 Price Review - Cost Allocation prepared by KPMG Consulting dated 30 May 2000
- Report to the Office of the Regulator-General on Electricity Demand Forecasting prepared by Sinclair Knight Merz Pty Ltd
- SKM Covering Letter dated 30 May 2000 - Report to the Office of the Regulator-General on Electricity Demand Forecasting prepared by Sinclair Knight Merz Pty Ltd
- Final Analysis of Distributors EDPR 2001 Submissions prepared by PB Power for the Office of the Regulator-General dated 30 May 2000
- Operating Expenditure Benchmarking Study - Study Undertaken on Behalf of the Office of the Regulator-General prepared by UMS Group Australia Pty Ltd dated 24 May 2000
- Response to the Office of the Regulator-General prepared by the Environment Protection Authority - Polychlorinated Biphenyls Notifiable Chemical Order - Impacts on Electricity Distribution Costs dated 18 May 2000
- Response to the Office of the Regulator-General prepared by the Office of the Chief Electrical Inspector - Safety Related Costs - Copy of Proposed Reply dated 12 May 2000
- Response to the Office of the Regulator-General prepared by the Office of the Chief Electrical Inspector - Electricity Distribution Price Review - Safety Related Costs dated 17 May 2000
- Report on Distribution System Losses prepared by PB Power for the Office of the Regulator-General dated 4 February 2000
- Protecting Consumer Interests in Electricity Distribution - Response to Office of the Regulator-General's February Issues Paper - 2001 Electricity Distribution Price Review Prepared by : - Pareto Associates Pty Ltd - April 2000
- Review of Distribution Price Controls in Victoria : Comments on NERA'S Proposed Approach and the Regulator-General's Consultation Paper Final Report - September 1998 Prepared by : Laurits R. Christensen Associates
  Updating Price Controls : Rationale and Practicalities A Report for Office of the Regulator General, Melbourne Prepared by : NERA, June 1998, London
- Updating Price Controls for Victoria's Power Distributors : Analysis and Options Final Report - September 1997 Prepared by :Laurits R. Christensen Associates
- Submission Format Responses to Regulator-General's letter dated 15 May 1999 – 7 responses

- 2001 Electricity Distribution Price Determination - Proposed Approach to Implementing Appeal Panel Decision (3 November 2000), Financial Model
- 6 responses to the Office's "Proposed Approach" paper
- Extensive correspondence on this topic

3. Retail Competition

- Information Booklet "Choice of Electricity Retailer"
- Guide to negotiating a retail contract
- Benchmarking study of the cost of half-hourly metering services and associated cost model
- A consumer research study commissioned from the Consumer Law Centre and the Consumers' Federation of Australia
- Consultation Paper no. 1
- Submissions in response to Consultation Paper no. 1 – 8 Submissions
- Recommendation of PB Power to the Office
- Consultation Paper no. 2
- Submissions in response to Consultation Paper no. 2 – 18 Submissions
- Draft Decision
- Submission in response to the Draft Decision – 13 Submissions
- Final Decision
- Draft Electricity Retail Code
- Final Electricity Retail Code
- Consultation Paper no. 3
- Submissions in response to Consultation Paper no. 3 – 17 Submissions
- Consultation Paper no. 4
- Submissions in response to Consultation Paper no. 4 – 13 Submissions
- Consultation Paper no. 5
- Submissions in response to Consultation Paper no. 5 – 11 Submissions
- Decision paper
- Consultation Paper no. 6
- Submissions in response to Consultation Paper no. 6 – 10 Submissions
- Consultation Paper no. 7
- Submissions in response to Consultation Paper no. 7 – 11 Submissions
- ORG Position Paper
- Consultation Paper no. 8
- Submissions in response to Consultation Paper no. 8 – 13 Submissions
- Consumer education research report – commissioned from Sweeney Research
- Ring Fencing in the Electricity and Gas Industries – Issues Paper
- 10 Submissions in response to the Ring Fencing Issues Paper
- Loy Yang B - Force Majeure Determinations and Approach Paper (July 2000) - The Office released the report on 1 August 2000
- AGL notice
- Open Letter from Dr John Tamblyn dated 10 November 2000, Application by AGLE for a Retailing Change in Tax Determination
- 7 responses

4. Licences

- 6 Distribution licences
- 9 Generation licences
- 22 Retail licences
- 2 Trader licences
- 2 Transmission licences

- 9 Submissions to Basslink's application for a transmission licence
- 4 Submissions to Aurora's application for a licence

- 10 Exemptions from holding a licence
- Proposed electricity licence variations
- Submissions responding to proposed licence variations

5. Industry Guidelines and Codes

- Electricity Industry Guideline no. 1
- Electricity Industry Guideline no. 2
- Electricity Industry Guideline no. 3
- Electricity Industry Guideline no. 4
- Electricity Industry Guideline no. 5
- Electricity Industry Guideline no. 8
- Electricity Industry Guideline no. 9
- System code
- Distribution code
- Supply and Sale code
- Retail Code
- Retail Tariff Metering Code

6. Performance Reports

- Report, Calendar Year 1999, Appendix D - Feeder Performance, 1997-1999
- Electricity Distribution Businesses - Comparative Performance January to June 1999 (February 2000)
- Comparative Performance for the calendar year 1998 (July 1999) Report , Calendar Year 1998 Feeder Performance, 1997-98
- Electricity Performance Report - 1 January 1998 - 30 June 1998 (Dec 1998)
- Electricity Distribution Businesses - Comparative Performance for the Calendar Year 1997
- Electricity Performance Report - July 1996 - Dec 1996 / Jan and Feb 1997
- Electricity Disconnections - April 1996 - June 1996
- Electricity Disconnections - Jan 1996 - March 1996
- United Energy - Outages and Surges (May 1996)
- Electricity Customer Service Indicators - Jan 1996 - June 1996 (Jan 1997)
- Electricity Customer Service Indicators - July 1995 - Dec 1995 (May 1996)
- Electricity Disconnections - July 1995 - Dec 1995 (Feb 1996)
- Electricity Customer Service Indicators - Nov 1994 - July 1995 (Oct 1995)

7. Memoranda of Understanding

- Memorandum of Understanding with the Energy Industry Ombudsman of Victoria (signed 14 October 1996).
- Memorandum of Understanding with the Office of the Chief Electrical Inspector (signed 29 January 1999).

B. GAS

1. Industry Structure And Regulatory Framework

- Gas Industry Act 1994
- Victorian Third Party Access Code for Natural Gas Pipeline Systems
- Discussion paper – Proposed Amendment to the Unaccounted for Gas Table in the Victorian Gas Distribution System Code
- 7 Submissions to the Unaccounted for Gas discussion paper
- Amended Unaccounted for Gas Table in the Victorian Gas Distribution System Code (UAFG).

2. Price Regulation

- Maximum Uniform Tariffs
- Distribution Tariffs – Multinet, Stratus, Westar.

Access Arrangements

- Gas Distribution System Access Arrangements - Consultation Paper
- The Victorian Third Party Access Code for Natural Gas Pipeline Systems

MULTINET, STRATUS AND WESTAR

- Multinet, Stratus and Westar Initial application
- Submissions from members of the public on the Application – 27 Submissions
- Supplementary Access Arrangement Information
- Consultancies Commissioned by the Office – 15 Consultancies
- Supplementary Submissions from the Applicant – 3 submissions
- *Draft Decision* by the Office
- Submission from Applicant on *Draft Decision* and Public Forums – 14 submissions
- Submissions from members of the public on the *Draft Decision* and Public Forums – 49 submissions
- Transcript of Proceedings - Public Forum on the Weighted Average Cost of Capital, 3 July 1998
- Transcript of Proceedings - Public Forum on other issues arising from the *Draft Decision*, 8 July 1998
- Final Decision by the Office
- Submissions from Applicant on *Final Decision* – 4 submissions
- Final Approval by the Office
- Revised Access Arrangements, Access Arrangement Information and Tariff Order – 7 arrangements
- Application to Revise Access Arrangements of Westar

GAS DISTRIBUTION TO NEW AREAS IN VICTORIA
MILDURA

- Initial Applications for Mildura
- Submissions from Members of the Public on the Mildura Application – 2 submissions
- Draft Decision for Mildura
- Extension of Time

- Submissions from Members of the Public on the Draft Decision for Mildura - 2 submissions
- Submission of New Maps for Mildura
- Final Decision for Mildura

EAST GIPPSLAND
- Initial Application for East Gippsland – 3 submissions
- Draft Decision for East Gippsland
- Extension of Time
- Submission from the Applicant on the East Gippsland Draft Decision – 1 submission
- Submissions from Members of the Public on the East Gippsland Draft Decision – 4 submissions
- Final Decision on East Gippsland

CARDINIA SHIRE
- Application for Cardinia Shire – 2 applications
- Submissions from Members of the Public on the Cardinia Shire Application – 9 submissions
- Approval

YARRA RANGES
- Initial Call for Expressions of Interest to Tender
- Expressions of Interest

APPLICATION TO REVISE ACCESS ARRANGEMENTS OF WESTAR
- 9 Applications
- Draft Decision
- Correspondence from TXU regarding Draft Decision
- Correspondence relating to discussions between the Office and TXU on the Barwon Heads Project
- 5 submissions

3. Retail Competition

- ***Error! Bookmark not defined.***
- Customer information brochure "Gas Contestability in Victoria - It's Your Choice!"
- Victorian Gas Distribution System Code
- 5 Submissions
- Public Discussion Paper regarding the extent of metering services for Tranche 3 of the gas contestability project
- 16 submissions
- Final Decision on Tranche 3

4. Licences

- 4 Distribution licences
- 13 Retail licences
- 4 Exemptions

5. Industry Guidelines and Codes

- Gas Industry Guideline no. 1
- Gas Industry Guideline no. 2
- Gas Industry Guideline no. 3 (commenced)
- Gas Industry Guideline no. 4
- Gas Industry Guideline no. 5 (commenced)
- Gas Industry Guideline no. 6

- Gas Industry Guideline no. 7
- Gas Industry Performance Indicators Information Specification
- Victorian Gas Customer Service Code
- Victorian Gas Distribution System Code
- Review of Gas Distribution System Code: 9 submissions
- Proposed Gas Distribution System Code - Version No. 6
- Victorian Gas Distribution System Code Change Procedures

6. Performance Reports

- Gas Performance Report - Disconnections for Non-Payment 1982-1998 (28 July 1999)
- Gas Industry Comparative Performance Report 1999 (October 2000)