RESPONSE TO UTILITY REGULATORS FORUM PAPER TO THE MINISTERIAL COUNCIL ON ENERGY

INTRODUCTION

The Energy Networks Association (ENA) recognises that a key issue under current consideration by the Ministerial Council on Energy (MCE) is its pending response to the recently completed Productivity Commission *Review of the Gas Access Regime*.

The MCE was recently provided with the views of the Utility Regulators Forum (URF) on certain aspects of the Productivity Commission's recommendations for amendments to the gas access regime. Energy networks businesses have significant concerns that the views provided by the URF do not provide an empirical or sound basis for the policy decisions on the future of the regime which the MCE is responsible for making over the next several months. In addition, the URF paper has failed to represent the Productivity Commission's recommendations for changes to the gas access regime in a fair and objective manner.

This paper seeks to provide the views of direct industry participants in the current gas access regime on the issues raised in the URF paper, with a focus on providing fuller and more balanced information in areas where the URF paper has provided unbalanced views not supported by evidence. This paper follows the format of the URF paper to assist in direct comparison of URF contentions with the actual outcomes of the Productivity Commission's review and the experience to date under the gas access regime which supported these recommendations.

Energy distribution network businesses are the largest single asset type regulated under the National Gas Code, with combined gas infrastructure assets valued at around $6 billion. Energy network businesses have considerable practical experience in the operation and application of the current regulatory regime, including areas of possible improvement.

OBJECTIVES AND AN OVERARCHING OBJECTS CLAUSE

The ENA concurs with the view of the Utility Regulators Forum that a lack of clarity about the fundamental objective of the gas access regime has created uncertainty about its interpretation and application for regulators, access providers and access seekers.

For the reasons detailed by the Productivity Commission and repeated by the URF, a binding objects clause as set out in Recommendation 5.1 of the final report of the *Review of the Gas Access Regime* should be a feature of a revised gas regime.

REGULATION, INFRASTRUCTURE INVESTMENT AND LONG-TERM RELIABILITY

The URF paper seeks to provide a view of the impact of regulation on infrastructure investment which is contrary to the findings of the Productivity Commission's two recent comprehensive and detailed reviews of third party access regimes. The paper asserts that:

> The Productivity Commission's recommended changes to address what it regards as being this detrimental consequence of regulation have not been supported by reference to facts, evidence or analysis.

In fact, the Productivity Commission's recommendations are supported by the Commission's own expert economic analysis, informed in part by evidence provided in more than 3500 pages of submissions to the review and 1000 pages of inquiry transcripts. Regulatory bodies collectively made submissions totalling around 800 pages in length to the Commission's inquiry (although it is notable that the Utility Regulators Forum itself provided no input to the inquiry). The contention of the URF paper that the Commission's final recommendations are not supported by facts, evidence and analysis is itself an untenable proposition – as demonstrated, for example, by the Commission's detailed and independent analysis on the source and effects of regulatory truncation under price regulation.[1]

Regulatory risk

The Productivity Commission's reviews of the national and gas access regimes have also established from first principles that the risks and consequences of underinvestment in essential infrastructure are asymmetric. That is, that the medium term costs to the community in infrastructure access prices being set too low are far higher than the risks of access prices being set too high.[2] The Commission has consistently identified that the risk of access prices being set too low – leading to underinvestment and regulatory failure - is the predominant risk currently facing infrastructure regimes.[3]

The view of the Utility Regulators Forum that there is 'little evidence' of unwarranted regulatory risk given the 'consistent' approach taken by Australian regulatory bodies in applying the building blocks approach to price regulation is unsustainable. The Productivity Commission comprehensively examined the issue of regulatory risk under the gas access regime, taking into account the views of sector participants as well as regulatory bodies. In contrast to the view of regulators, the Commission found that regulatory risk under the gas access regime was high and proposed several recommendations to address this issue.[4] Some of the risks identified by the Commission included: coverage risk, parameter risk and asset stranding.

Despite assertions to the contrary, the past decisions of Australia's nine energy regulatory bodies do *not* provide a consistent picture of likely regulatory approaches for current or potential investors in regulated energy infrastructure. In fact, in the very areas specified by the URF as those where a considerable degree of consistency has been achieved, inconsistency in regulatory approaches has been marked.[5] Indeed, bringing about a greater degree of consistency in approaches to regulatory pricing determinations is presumably one contributing rationale for the MCE's decision to implement a single national energy regulator.

Supporting evidence is also particularly weak for the argument contained in the URF paper that potential investors would be able to predict 'within fairly narrow ranges' the approach likely to be taken by Australian regulators on regulated asset values. In its May

[1] Productivity Commission *Review of the Gas Access Regime – Inquiry Report*, June 2004, Appendix B, p.537
[2] Productivity Commission *Review of the National Access Regime – Draft Report*, March 2001, p.71
[3] Productivity Commission (March 2001), p.90 and see also Productivity Commission *Annual Report 2000-01*, February 2002
[4] Productivity Commission (June 2004), p.137
[5] Recent examples of areas of inconsistency in regulatory decisions include: risk characteristics of regulated energy networks, whether returns should be measured under a pre-tax or post tax approaches, whether feasible ranges should be utilised in approving rates of return and how efficiency gains should be shared with consumers over time

2003 Final Decision on transportation tariffs the WA economic regulator applying the National Gas Code detailed its view that under the asset valuation provisions of the regime variations of ± 20 per cent (or up to $400 million in the specific instance) could reasonably occur.[6] The ENA notes also that while regulatory authorities have shown some degree of consistency in seeking to approve regulated asset values in the lower bounds of plausible ranges, in a series of significant instances (Epic Energy DBNGP, Moomba-Adelaide Pipeline System and Moomba-Sydney Pipeline) these decisions have been overturned or amended by review bodies on the basis that they are flawed or based on fundamental errors of law. Regulators (in particular the ACCC) being consistently found in error on key issues is not a strong argument in favour of the URF's position.

Infrastructure investment

The URF paper claims that 'the evidence would suggest that rates of return set by regulators have not been low in commercial terms'.

In fact, substantive evidence suggests that rates of return estimates approved by Australian regulatory authorities have *not* been high when compared either with normal commercial returns or international regulatory practice.[7] The most comprehensive study on Australian regulatory rates of returns to date was carried out by the Network Economic Consulting Group in 2003. This review covered a number of infrastructure sectors, surveying over 100 regulatory decisions across Australia, the United States, the United Kingdom, Canada, France, Ireland, the Netherlands and New Zealand. It found that approved returns in the regulated gas and electricity network sector were either equivalent to or significantly below those provided for in comparable regulatory decisions by overseas regulators.[8] The expertise of the lead participant in this study has recently been recognised by his appointment to the Prime Minister's taskforce on exports and infrastructure.

Regulated assets at times trading at a 'premium' to their regulatory value does not provide substantive evidence on the appropriateness of current regulated rates of return or approaches. Firms operating across a range of normal competitive markets routinely trade at a premium over their actual asset value, due to a range of factors which have no relationship with regulatory approaches to access prices. Indeed, evidence shows that equity markets themselves routinely trade at a 'premium' over total actual asset (or book) values.[9] That is, competitive equity markets themselves fail to evidence the relationship (1:1 ratio) which regulatory authorities are proposing to use as a measure of their approaches.[10] Indeed, individual Australian regulatory bodies have expressed considerable caution about the difficulties of drawing robust conclusions on the adequacy of regulated returns from an examination of market transactions or valuations.[11]

The Productivity Commission's *Review of the Gas Access Regime* has found that, contrary to views expressed in the URF paper, regulatory risk is a significant issue for investors and that existing regulatory approaches are likely to be distorting investment in

[6] OffGAR *Final Decision - Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline*, May 2003, para 121
[7] Network Economics Consulting Group *International comparison of WACC decisions*, September 2003, p.69 <www.pc.gov.au>
[8] NECG (September 2003), p.69
[9] See KPMG *Submission to the Essential Services Commission – Response to ESC Draft Decision – 2003 Review of Gas Access Arrangements*, August 2002, p.22-36 <www.esc.vic.gov.au>
[10] In 2000 one prominent study undertaken showed that the ratio of total equity market values to replacement assets for all listed firms (with unregulated firms obviously predominating listed regulated entities) to be around 2.5 in 1998. Previous benchmark studies based on aggregated estimates of the ratio of market value to replacement costs by Brainard, Shoven and Weiss (1980) showed the average ratios for each of the years 1959 to 1977 ranged from 0.86 to 2.08. See KPMG (August 2002)
[11] Victorian Essential Services Commission *Review of Gas Access Arrangements – Final Decision*, October 2002, p.372

gas networks and pipeline infrastructure.[12] The URF paper seeks to argue that there is no need for further guidance to prevent regulators from setting non-commercial rates of return. The paper states:

> In fact, to do so would create the real possibility of setting rates of return too high, which would be likely to encourage inefficient investment and/or merely excessive rents to the service provider.

The ENA does not understand how providing guidance that access prices should at a minimum reflect the actual commercial and regulatory risks faced by service providers would create the possibility of 'excessive' rates of return. Similar guidance proposed by the Productivity Commission in relation to level of access prices has recently been adopted by all Australian governments in their final response to the *Review of the National Access Regime* released in February 2004.

Long-term reliability

An additional issue raised by the URF paper is the accountability of service providers for long-term service and reliability outcomes.

Service providers across Australia are accountable through a number of mechanisms for long-term service reliability and performance. In many jurisdictions, minimum service and reliability outcomes are specified in operating licences, with breaches subject to significant financial and other penalties. In a growing number of jurisdictions guaranteed service levels provide significant accountability for a range of service quality outcomes (from meeting appointment times to compensation for unplanned outages).

The operation of incentive-based regulation has in some jurisdictions led to actual capital expenditure being below that forecast by regulatory authorities at the outset of the previous regulatory period. In other jurisdictions, actual capital expenditure which supports ongoing reliability and service quality has been higher than was originally forecast to be required by regulatory authorities. Under incentive-based regulation where past capital spending levels have been lower than forecast the financial benefit of this lower expenditure requirement has been distributed to energy consumers.[13] Contrary to the arguments contained in the URF paper, there is no consistent or conclusive evidence that lower than forecast levels of capital expenditure have in any way compromised service quality or reliability outcomes.[14]

LIGHT-HANDED REGULATION/MONITORING

The ENA supports the development of lighter-handed regulatory approaches, including the price monitoring option supported by the Productivity Commission and Utility Regulators Forum.

The Productivity Commission has provided details of the operation of a price monitoring options under a revised gas access regime. In particular, the Commission emphasises that a monitoring option must be truly 'light handed' and not develop into an intrusive and costly form of regulation.[15] This caution seems warranted, as the approach of the URF

[12] Productivity Commission (June 2004), Finding 4.3 p.xlii
[13] In net present value terms consumers share in around 70 per cent of the value of unanticipated efficiency gains. Consumers automatically receive 100 per cent of the value of forecast efficiency gains under Australian regulatory approaches.
[14] See for example, VESC Media Release 'ESC to strengthen incentives for reliable electricity supply', 24 March 2004 and VESC *Electricity Distribution Businesses Comparative Performance – September 2004* <www.esc.vic.gov.au>
[15] Productivity Commission (June 2004), Recommendation 8.1

paper appears predicated on a false assumption that monitoring obligations ought to possibly be as intrusive and restrictive as those applying under cost-based regulation. The Productivity Commission's model clearly and specifically rejects this proposition.[16]

THE APPROACH USED FOR SETTING REFERENCE TARIFFS

The ENA endorses the URF's statement of support for the need to clarify provisions in the existing regime used in setting reference tariffs. This is a major conclusion of the Productivity Commission's comprehensive review with which regulated energy businesses concur and the Commission's recommendations directly address this issue.

Role of the regulator in assessing Access Arrangements

The URF paper cites apparent concerns with a key recommendation of the Productivity Commission for amendments to Section 8.31 of the Code. The effect of the Commission's proposed amendment is to provide further guidance and clarity to regulatory bodies over the process for approving appropriate rates of return under the Code. Recommendation 7.9 specifies that it is the role of the regulator to assess whether the service provider's proposed method for determining an appropriate rate of return has a plausible conceptual basis and whether the values used in applying the method lie within a plausible range of estimates.[17]

Implementation of Recommendation 7.9 would not, as suggested by the URF paper, 'seriously compromise' the regulatory regime. The recommendation in fact represents a clarification completely consistent with the National Gas Code's existing model of 'propose-respond'. Under this model it is the obligation of a service provider to develop an Access Arrangement and proposed tariffs which meet the objectives and requirements specified in Code provisions. This model was developed by agreement between gas infrastructure owners and governments in 1996, and was the underpinning for the agreement by infrastructure owners to the introduction of an access regime which had substantial impacts on the exercise of existing property rights. In setting an appropriate rate of return the existing Gas Code provides that the service provider may use a range of well-accepted financial models (such as the Capital Asset Pricing Model). The propose-respond model embodied in the Gas Code was recently used as a basis for Western Australia's new electricity network access code, thus endorsing its contemporary relevance in any considerations of future generic regulatory models. Elements of the third party access regime established by Part IIIA of the *Trade Practices Act* also share some of the characteristics of a 'propose-respond' model.

Clarifying that it is not the role of the regulator to both determine the detailed cost of capital methodology to be used and to select each cost of capital input parameter is also consistent with finding of review bodies interpreting the Gas Code. The Australian Competition Tribunal in the *GasNet* matter was requested to assess an ACCC claim that under the terms of the Gas Code the ACCC was required to determine a specific rate of return. The Tribunal rejected this claim as inconsistent with the provisions of the Code, stating:

> Contrary to the submission of the ACCC, it is not the task of the Relevant Regulator under s 8.30 and s 8.31 of the Code to determine a 'return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Service'. The task of the ACCC is to determine whether the proposed

[16] Productivity Commission (June 2004), Recommendation 8.2 and 8.5, 8.6
[17] Productivity Commission (June 2004), p.lii

> AA in its treatment of Rate of Return is consistent with the provisions of s 8.30 and s 8.31 and that the rate determined falls within the range of rates commensurate with the prevailing market conditions and the relevant risk.[18]

The *GasNet* judgement also referenced earlier judicial interpretations of the issues involved in approving rates of returns under the Gas Code. The Tribunal noted:

> It is clear in the reasoning in *Michael* that there is no single correct figure involved in determining the value of parameters to be applied in developing an applicable Reference Tariff. The application of the Reference Tariff Principles involves issues of judgement and degree. Different minds, acting reasonably, can be expected to make different choices within a range of possible choices which nonetheless remain consistent with the Reference Tariff Principles.[19]

The provisions of the Gas Code and their interpretation by review bodies do not support the position that clarification of the scope of the regulator's role in assessing pricing proposals has the potential to 'substantially change' the application of the regime in a manner which may not have been intended by governments. In fact, the Productivity Commission's recommendation merely adds further clarity around existing principles of the Code regarding the role of the regulator established at the time the regime was agreed.

The claim that adoption of Recommendation 7.9 may 'impede' the capacity of regulatory bodies to balance the interests of service providers with those of the community also can not be supported by evidence from actual regulatory decisions made subsequent to the *GasNet* matter. The three subsequent gas distribution network pricing reviews have proceeded according to the processes set out in the Gas Code, and regulatory authorities have faced no obstacles in the effective and timely finalisation of decisions resulting from the clarification of regulatory roles offered by the *GasNet* case. Indeed, recent decisions by regulatory authorities have emphasised the degree of discretion which regulators continue to retain (and will continue to retain under the Productivity Commission's recommendations) in resolving conflicts between the Gas Code's pricing principles.[20]

In no regulatory price determination since the *GasNet* matter has any regulatory body claimed that their decisions have been negatively impacted or impeded by the clarification of their role which the case provided – and which the Productivity Commission's recommendation would explicitly integrate into the Code. In fact, many regulatory bodies have actually integrated concepts of feasible ranges for cost of capital parameters as part of their Access Arrangement assessment process. As an example, the most recent IPART gas distribution network pricing decision concluded that a reasonable range for a cost of capital was from 5.9-7.3 per cent.

Providing scope for alternative pricing methodologies

The URF cites concerns with a Productivity Commission recommendation that service providers should be free to propose alternative pricing methodologies consistent with the principal objective of the regime (*Recommendation 7*.5).

Regulated energy network businesses do not consider these concerns well-founded, as the Commission's recommendations simply remove an unintended technical barrier in the provisions of the Gas Code to the development of alternative methodologies (a core intended design feature of the regime). This unintended barrier was created by s.8.5 of the Code, which required that in proposing alternative pricing methodologies that the alternative methodologies be able to be expressed in the form of one of the three existing

[18] *Application of GasNet Australia (Operations) Pty Ltd* [42]
[19] *Application of GasNet Australia (Operations) Pty Ltd* [29]
[20] See for example IPART *Revised Access Arrangement for AGL Gas Networks – Draft Decision*, December 2004, p.9

cost-based approaches listed in the current Code. The Productivity Commission found that this restriction was an unintended impediment to the development of less costly lighter-handed forms of price control.

Without this amendment it is doubtful whether alternative approaches such as the total factor productivity benchmarking approach currently being investigated by the Victorian Essential Services Commission (VESC) could be successfully implemented under the Gas Code. This alternative form of regulation was initially proposed by Citipower as the basis for electricity distribution pricing around five years ago. The VESC's choice to adopt a substantial work program to carry out a possible TFP-based price adjustment from 2010 does not support the generic assertion made in the URF's paper that unless this recommendation is rejected, regulatory bodies will inevitably be faced with relying on pricing methodologies which systematically favour service provider's interests. As previous work undertaken by the URF on TFP-based regulation indicates, alternative pricing approaches have the theoretical potential to have widely varying financial impacts on a range of network distribution businesses.

REGULATORY ACCOUNTS DATA AND INFORMATION GATHERING POWERS

The Productivity Commission *Review of the Gas Access Regime* comprehensively examined the information gathering and regulatory accounting provisions of the National Gas Code and Law.

Following an assessment of the views of regulatory bodies, end users and service providers the Commission *rejected* a range of regulator proposals to dramatically expand their powers to collect a wide array of information between Access Arrangement reviews. Instead, the Commission determined that an obligation on service providers to collect and maintain data on the variables used as the basis for cost allocations should be imposed (*Recommendation 7.12*). Whilst the URF claims that the Commission's decisions on information gathering powers 'appear to lack clarity', in fact there was no lack of clarity in the Commission's rejection of a number of regulator proposals to increase overall information powers. The Commission found:

> FINDING 7.7
>
> Regulators are currently seeking to have their powers under the Gas Access Regime extended so they can obtain information between access arrangement reviews. This extension has the potential to add unnecessarily to service providers' compliance costs.[21]

The Commission went on to note that the gas access regime should be amended to prevent regulatory bodies engaging in information power 'forum-shopping' – that is applying information powers provided for other unrelated purposes (such as licensing compliance) to seek information for the purpose of assessing access arrangement proposals.[22] The Productivity Commission's recommendations on information powers and regulatory accounts, which extend powers in some areas while seeking to constrain the total costs, provide an expanded scope of information which regulatory bodies could require from service providers. In many cases, service providers consider that the expansions supported by the Commission are not required, and have the potential to introduce excessive compliance costs. Further expansions of powers *beyond* the recommendations of the Commission would lead to a further unbalancing of the regime

[21] Productivity Commission (June 2004), p.314
[22] Productivity Commission (June 2004), Recommendation 7.14, p.314

away from its intended goal of providing a light-handed and cost-effective regulatory framework.

TIMELINESS AND APPEALS PROCESSES

Energy network businesses note the concern of regulatory bodies with the Productivity Commission recommendation to remove the ability of a regulator to extend access arrangement review periods on multiple occasions. Most recent energy network pricing decisions under both the gas and electricity regimes have taken approximately 11-12 months. This period reflects both the complexity and breadth of issues to be investigated and determined at these reviews, and comparable international regulatory experience.

Regulated network businesses consider that ensuring the regime results in the development of price review determinations based on a robust and reasonable consideration of relevant information should be a key priority. To this end, fixed or inflexible time periods for regulatory decisions are less important than ensuring adequate access to merits-based reviews on pricing determinations. The ENA notes that in 4 out of the 5 merits review applications made under the gas access regime relating to Access Arrangement approvals the merit appeal bodies have found significant errors which have required substantive amendments to the original decision. The assumption in the URF paper that the existing unlimited scope for regulatory consultation and analysis is a guarantee of high-quality error free decision-making is not supported by empirical evidence to date.

The URF paper inaccurately claims that the Productivity Commission's proposed recommendations in respect of grounds of appeal under the *Gas Pipeline Access Law* would task merit review bodies with replicating entirely the pricing decisions made by regulatory bodies. In fact, existing procedural restrictions on presenting new information to the review body and the issues specified in the review application would naturally form a basis of limiting the issues under consideration by the review body.[23] The proposed recommendations would not, for example, remove the existing and effective provisions of Section 39 (4) which permit review bodies such as the Australian Competition Tribunal to confine the scope of its reviews to material and significant matters where there is a likelihood of the original decision being varied.

It is difficult to reconcile the URF's unfounded concern regarding review bodies being tasked with replicating entire price review decisions with several statements in the paper regarding the risk of "cherry-picking" of regulatory decisions. "Cherry-picking" of regulatory decisions in this context appears to refer to service providers specifying particular areas of a decision in an application for review which they believe are unreasonable or based on an error of fact. In fact, the detailed specification of alleged deficiencies in an administrative decision is a common feature of efficient administrative review arrangements.

From these two apparently divergent concerns, it is unclear whether the URF favours review arrangements which look at the decision from a 'holistic perspective', or whether the URF's expressed doubts regarding the possible inefficiencies of this approach prevail in this regard.

[23] See for example *Gas Pipelines Access Law*, Section 39 (5)

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