



**The Australian Gas Association**

**Submission to the Utility Regulators Forum**

**Comparison of Building Blocks and  
Index-based Approaches**

Response to Farrier Swier Consulting Discussion Paper

**15 November 2002**

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# Overview

On 11 September 2002 the Utility Regulators Forum released the discussion paper *Comparison of Building Blocks and Index-Based Approaches* commissioned from Farrier Swier Consulting. The discussion paper examines issues relating to the current cost-based model of access pricing applied under third party access regimes (including the National Gas Code). The Australian Gas Association (AGA) welcomes the discussion paper as a useful contribution to an aspect of the wider ongoing debate regarding access regulation.

The discussion paper was released at the same time as several important developments in access regulation with broad significance for public policy. It is important to note that the discussion paper addresses in detail only a relatively narrow range of issues associated with several alternative models of access pricing.

Critically, the discussion paper was completed prior to three significant policy developments. These developments are the:

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

Key assumptions and aspects of the discussion paper appear to be inconsistent with the policy directions and implications of each of these developments. This will require policy makers and the Utility Regulators Forum to reconsider some of the conclusions and approaches adopted in the paper.

While the discussion paper is designed to serve as one input into broader policy development processes, some parts of the paper make important policy judgements that are properly the concern of government policy making agencies, and are inconsistent with current policy directions adopted. As an example, it is clearly the role of governments, on behalf of the wider community, to define the objectives of regulatory frameworks, and the role of regulatory authorities to administer these frameworks.

The AGA is also concerned to ensure that any further work initiated on assessing alternative access pricing models does not lead to increased intrusion and costly open-ended information-gathering processes.

Comparing access pricing models is a complex and difficult task. The AGA considers that it should be done carefully with reference to whether any existing or alternative access pricing options will deliver substantial improvements over likely unregulated outcomes. Further, assessments should closely consider the impact of different access pricing models on greenfields gas distribution developments.

# Background

This submission responds to the Utility Regulators Forum commissioned paper *Comparison of Building Blocks and Index-Based Approaches* by Farrier Swier Consulting released in September 2002.

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

Gas distribution businesses deliver natural gas to an estimated 3.5 million Australian households through distribution pipelines networks over 73 000 kilometres in length. These distribution networks are valued at over \$5.5 billion, and each year gas distribution businesses undertake capital investment of approximately \$250 million in network reinforcement, expansion and greenfields extensions.

## Key developments in access pricing regulation

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

Three significant developments have occurred. These developments are:

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

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

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

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

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

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

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

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

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

Importantly, the Commission recognised that the possibility of regulatory failure and error arose from a number of factors which were not directly related to any failing on the part of regulatory authorities:

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

The AGA concurs with this finding and recognises that under the current flawed National Gas Code, for example, regulators have a difficult task of reconciling

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

<sup>2</sup> Productivity Commission (2001), p.xxi

<sup>3</sup> Productivity Commission *Annual Report 2000-01*, February 2002, p.16

<sup>4</sup> Productivity Commission (2001), p.90

<sup>5</sup> Productivity Commission (2001), p.91

complex and conflicting considerations with inadequate guidance from the regulatory framework itself.

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

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

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

## **Interim Commonwealth Government response**

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

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

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

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

The Commonwealth has also indicated that it supports continued development of alternative access pricing models. It is clear from this element of the Commonwealth response that it would be inappropriate and inconsistent with the broad policy

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<sup>6</sup> Productivity Commission (2001), p.xxv

<sup>7</sup> *Government Response to Productivity Commission Review of the National Access Regime*, September 2002, p.1 <[www.treasury.gov.au](http://www.treasury.gov.au)>

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

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

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

direction set by the Commonwealth Government for any changes to be introduced to access pricing that have the effect of entrenching intrusive forms of cost-based access pricing.

The AGA considers that the appropriate model for access pricing under the National Gas Code is a matter for further consideration in the forthcoming review of the gas access regime. While the discussion paper provides a useful input into that process, it is critical that fundamental policy issues involved in access pricing are resolved following an independent review in a transparent policy process with a key role for regulated businesses whose fundamental property rights are directly affected.

## **Epic Energy judgement**

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

The WA Supreme Court decision is a development with critical implications for access pricing, particularly for assets regulated under that National Gas Code. The case examined for the first time the correct application and interpretation of a number of key access pricing provisions of the Code. The recent Supreme Court judgment on the appeal has particular relevance to the issues of

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

Many aspects of Court decision support ongoing concerns expressed by regulated gas businesses that regulatory outcomes and the current gas access regime have failed to provide potential investors in regulated gas infrastructure assets with sufficient certainty and incentives to make large sunk investments. The Court decision and other ongoing judicial review processes in connection to regulatory determinations under the National Gas Code also raises significant questions over the stated assumption in the paper that as the cost-based building blocks approach develops, the scope for disputes relating to regulatory decisions becomes more limited.<sup>11</sup>

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<sup>11</sup> See Farrier Swier Consulting *Comparison of Building Blocks and Index-Based Approaches*, June 2002, p.71

### ***Workably competitive markets and access pricing***

One key outcome of the WA Supreme Court ruling is that it has been established that the National Gas Code and similar industry-specific access regimes are designed to promote access pricing outcomes similar to those which would emerge in ‘workably competitive’ market.<sup>12</sup> Importantly, the Court signaled that access regulation cannot and should not be expected to replicate outcomes under a perfectly competitive market, a concept which the Court considered a theoretical abstraction.<sup>13</sup> The Court also concluded that a workably competitive market was a process, rather than a fixed outcome, and that it could in theory be consistent with a degree of market power, even over a prolonged period.<sup>14</sup>

Several aspects of the paper appear inconsistent with these conclusions. The paper compares in detail several price-setting methodologies which it may be possible to adopt in the future, and the current building blocks approach. A common theme underlying the assessment is the now discredited presumption adopted by regulatory authorities that if a given theoretical model is applied ‘correctly’, a precisely determinable ‘right’ access price will be obtainable.

A narrow and deterministic approach to the setting of access prices has been a key concern of regulated gas businesses since the introduction of the current National Gas Code in 1997, and the AGA considers that the retaining of such an approach in the assessment of future alternative access pricing models is unhelpful and inconsistent with the judgement of the WA Supreme Court.<sup>15</sup> Under an approach seeking to promote outcomes consistent with a workably competitive market, and given the recognised information constraints and possibility of significant regulatory errors, the concept of determining a precise ‘correct’ access price is flawed. Further, as the Productivity Commission has noted, such a prescriptive approach can deter investment:

In relation to the level of prices, attempts to be too precise in removing the potential for service providers to earn monopoly rents carries significant risk for investment.<sup>16</sup>

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

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

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

<sup>14</sup> *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [128]

<sup>15</sup> See for example *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [143]

<sup>16</sup> Productivity Commission (2001), p.339

## ***Objectives of the National Gas Code***

The paper also adopts a legally unsupportable assumption regarding the objectives of the National Gas Code. Following the common practice of previous regulatory determinations, the discussion paper cites Section 8.1 of the National Gas Code as containing the objectives and principles of network access pricing.<sup>17</sup> This approach may have been adopted due to the guidance provided to Farrier Swier Consulting in the project brief prepared by the Utility Regulators Forum, which specifically refers to Section 8 with reference to the duties and obligations of regulators.<sup>18</sup>

A key finding of the WA Supreme Court judgement was that regulatory decisions on access prices should take into account a number of key principles set out in Section 2.24 of the Code, and that in setting access prices regulators should have regard to a wider range of social and policy factors, not just economic theory.<sup>19</sup> Other Court findings of the correct application of Section 8.1 and Section 2.24 provide further evidence that the discussion paper has proceeded from flawed assumptions. The Court determined that the application of the principles in Section 8.1 would almost invariably involve a reconciliation of a number of competing considerations set out in Section 8.1 (a)-(f).<sup>20</sup> Where these principles conflicted, the regulator was determined to have an obligation to reconcile this conflict with direct reference to the broad principles described in Section 2.24.<sup>21</sup> The discussion paper fails to refer to this key section of the Code, and consequently gives no consideration to its impact.

Given the WA Supreme Court judgement the assumption made by the paper of the scope and nature of the network pricing objectives and principles is clearly legally unsupportable. It appears that the erroneous assumption can be traced to guidance provided by regulators to Farrier Swier Consulting based on a narrow economic theory driven interpretation of the National Gas Code which has been overturned by the WA Supreme Court. This highlights the need for policy makers and other stakeholders such as regulators to carefully examine the impact of the WA Supreme Court judgement in future decisions on the development of access pricing regulation.

## **Appropriate policy development approaches**

The AGA is concerned that some elements of the paper assume an inappropriate policy development role for regulators.

Governments and policy agencies have a key role to play in establishing, developing and reviewing regulatory frameworks such as the gas access regime. This role should be separate to that of regulatory authorities, which are charged by governments with administering regulatory frameworks and arrangements. Regulatory authorities may in the course of administering access regimes acquire some specialist expertise in the operation of access regimes which may be one of several appropriate inputs into

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<sup>17</sup> Farrier Swier Consulting (2002) p.12, see also p.106

<sup>18</sup> See 'Appendix 1 - Project Brief' in Farrier Swier Consulting (2002) p.100

<sup>19</sup> *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [55, 152-153]

<sup>20</sup> *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [136]

<sup>21</sup> *Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 [85, 136]

government policy making processes, just as regulated businesses will acquire practical experience of the impact of regulation on their operations and investment decisions. It is critical, however, that institutional arrangements reflect that determining the objectives of access regulation, policy development and implementation remains ultimately an area for government decision-making.

Insufficiently clear separation between policy development and administration can lead to a lack of certainty, accountability and transparency for regulated businesses that is inappropriate and damaging from a public policy viewpoint. This is particularly the case for a sector with large sunk investments in long-lived assets which require significant levels of ongoing investment (approximately \$250 million in capital expenditure per annum in the case of gas distribution networks).

A lack of separation can also lead to potentially conflicting signals about future developments in the regulatory framework being given by policy-making agencies of governments and regulatory authorities. As discussed previously, the Utility Regulators Forum discussion paper emphasises the importance of retaining cost-based elements of the current building blocks approach even if a form of model that sets access prices based on external productivity measures is adopted. In contrast, the Commonwealth Government's interim response to the Productivity Commission's *Review of the National Access Regime* proposed a set of modified access pricing principles for Part IIIA of the Trade Practices Act with an explicit goal of not restricting the adoption of future regulatory approaches that do not rely on cost-based methodologies, such as benchmarking and productivity-based approaches.<sup>22</sup>

This specific inconsistency and other more general inconsistencies with policy developments apparent in the direction of the discussion paper reinforce the need for regulators to remain cognisant of policy guidance provided by governments and developments in the broader regulatory framework.

There are a number of other examples of elements of the discussion paper that reflect an inadequate distinction between the role of regulatory authorities in applying a regulatory framework, and the role of governments in establishing the objectives, principles and application of regulation. These are discussed below.

## **Objectives of access regulation**

The paper makes the important point that the form of access regulation will depend on the specific objectives sought. The objectives of access regulation have been subject to considerable public debate through the Productivity Commission's *Review of the National Access Regime* over the past two years. This process considered a number of alternative approaches for defining the objectives of access regulation, and culminated in a recommendation, accepted in a modified form, for a formal objects clause to be added to Part IIIA of the *Trade Practices Act 1974* to serve as a common basis for the objectives of associated industry-specific regimes such as the National Gas Code.

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<sup>22</sup> *Government Response to Productivity Commission Review of the National Access Regime* (2002), p.5

The discussion paper, however, appears to adopt an assumption that the objectives of access regulation should be identified, developed and prioritised by regulatory authorities. The paper states:

...regulators and policy makers need to clearly identify, articulate and prioritise the specific regulatory objectives to apply at a point in time.<sup>23</sup>

The AGA considers this reflects a fundamentally mistaken view of the role of regulators. As outlined above, it is the appropriate role of governments and the broader communities they represent to define the objectives, nature and coverage of access regulation. The obligations upon regulatory authorities are to apply established regulatory frameworks and clearly articulate both how determinations are consistent with these frameworks and the reasons underlying exercises of regulatory discretion. This task is particularly challenging. It is a task only made more difficult if regulatory authorities mistakenly assume that it is their role to attempt to, in partnership with policy makers who have recently made their views on these issues clear, redefine or prioritise the objectives of access regulation.

## **Coverage and methodologies of access regulation**

The paper also makes an unsupported policy judgment regarding the extent of access regulation in the form of price caps over assets likely to feature ongoing monopoly power. The paper states that:

This is likely to cover the bulk of existing assets and a significant level of new capital investment in the foreseeable future.<sup>24</sup>

It is unclear on what basis Farrier Swier Consulting adopts this assumption, which does not appear to be consistent with a range of policy developments and directions in the gas infrastructure sector. As an example, the recently built Duke Eastern Gas Pipeline has successfully argued against coverage under the National Gas Code, and the recent interim Federal Government response to the Productivity Commission inquiry canvasses the development of 'access holidays' for greenfields gas transmission pipelines and distribution network extension/augmentation projects. Thus at least in the gas infrastructure sector, the judgement adopted by the Utility Regulators Forum paper appears at variance to the policy directions being supported by the Commonwealth Government.

Similarly, where possible, it is critical for the certainty, transparency and accountability of regulatory decision-making that appropriate access pricing methodologies are defined adequately by the regulatory framework. The discussion paper states that discretionary regulatory judgements may be involved in a regulator selecting the methodologies to be employed in reaching regulatory determinations.<sup>25</sup> While appropriate for some technical issues, in the AGA's view key access pricing principles and methodologies should be adequately defined and established by the regulatory framework. This contention has been strongly reinforced by the interim

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<sup>23</sup> Farrier Swier Consulting (2002), p.83 see also p.93

<sup>24</sup> Farrier Swier Consulting (2002), p.10

<sup>25</sup> Farrier Swier Consulting (2002), p.24

Commonwealth Government response to the recommendations of the Productivity Commission inquiry and the WA Supreme Court judgement.<sup>26</sup>

## Further development of alternative options

A major recommendation from the discussion paper is that further work be undertaken to scope the potential for the implementation of alternative index-based approaches.

In several places in the discussion paper the potentially increased information requirements of index-based approaches are emphasised and a significant number of the recommendations for areas of further work relate to the issue of information collection requirements, data collection and benchmarking.<sup>27</sup>

An emphasis on increasing information requirements is in contrast to a number of significant developments in the area of access regulation over the past two years.

The Productivity Commission has indicated that movement to lighter-handed frameworks is appropriate, and there is a consensus that the current application of the building block cost of service approach is extremely information-intensive. Given this, it is unclear how movement towards lighter-handed models of regulation can be used to justify further information requirements, particularly as some existing information provisions under the National Gas Code remain largely unused by Australian regulators. Currently, the National Gas Pipeline Advisory Committee is considering proposals sponsored by the NSW Independent Pricing and Regulatory Tribunal for dramatically increasing the scope of information gathering powers under the Code. The AGA considers that these proposals are completely inconsistent with the policy direction of both the *Review of the National Access Regime* and the interim Commonwealth Government response, and that the further development of such proposals prior to the planned review of the gas access regime is inappropriate.

The AGA further notes that the discussion paper adopts an apparent double-standard in questioning whether sufficient information exists to effectively implement index-based approaches whilst ignoring the regulatory discretion involved in and arbitrariness of the current application of the capital asset pricing model and determinations of the 'x-factor' under the existing building blocks approach.

Further work directed to establishing whether index-based approaches are feasible may be legitimate. The AGA does not support, however, further expansions of information requirements under the current National Gas Code which will have the effect of entrenching, and increasing the intrusiveness of, cost-based approaches.

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<sup>26</sup> Productivity Commission (2001), p.142

<sup>27</sup> See for example Farrier Swier Consulting (2002), p.91 and p.94

## Comparing alternative access pricing options

The AGA has a number of high-level comments relating to the comparison made between possible alternative regulatory approaches in the discussion paper. As the Farrier Swier Consulting paper states, the implementation details of an access pricing model will have a key determinative role in the appropriateness of the overall approach. These comments therefore relate to some of the principles that must underpin a balanced and transparent assessment of alternative access pricing models

### Recognising flaws in current access regulation

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

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

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

Critically, the AGA considers that the discussion paper gives inadequate weight to the Productivity Commission's findings on the high risk of regulatory error and failure under the current 'building blocks' cost-based approaches employed by Australian regulators.<sup>28</sup>

### Assessing the impact of technological change

A further concern in the analysis of the paper is that it contains no discussion about the expected rate of technological change in the gas and electricity distribution sector. It is widely anticipated that there will be a relatively low rate of technological change in the distribution network sector over the next several decades, with opportunities for productivity improvements generally limited to the further application of existing productivity boosting technologies (such as information and communications technologies) to specific areas of distribution businesses' operations. One contributing factor to the low rate of technological change in the gas distribution sector may be the low access prices determined by Australian regulatory authorities, which constrain incentives for research and development. The capacity for low access prices to stifle dynamic efficiencies and technical innovation was a key concern of the Hilmer Committee's review of national competition policy.<sup>29</sup>

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<sup>28</sup> Productivity Commission (2001), p.90

<sup>29</sup> *National Competition Policy – Report by the Independent Committee of Inquiry*, August 1993, p.253

An expected low rate of technological change will have important implications for the appropriate form and application of access pricing regulation that may be applied in the future. It is clear, for example, that many efficiency gains associated with industry restructuring and competition have been achieved, and that the magnitude of forecast future efficiency improvements contained in previous regulatory determinations involving significant one-off price falls are unlikely to be repeated in any future cost-based decisions. Similarly, any productivity index-based approaches should be constructed with an understanding that they are likely to result in relatively smaller overall price adjustments than have been previously imposed.

## **Scope of comparison of alternative approaches**

The paper compares a small number of potential alternative approaches. These include:

- ? the current building block approach
- ? a productivity index-based approach with periodic cost-based resets
- ? a frontier approach
- ? indexation against basket of comparable service

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

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

The AGA and its core members are currently examining a range of possible access pricing models and combinations, and do not advocate any single preferred approach. It would be useful, however, if future work included an examination of a broader range of possible access pricing models and combinations of approaches.

The productivity index-based model ultimately favoured by the discussion paper appears to have key elements of the building blocks cost of service approach (e.g. regular cost-based reviews). The AGA acknowledges the considerations which led Farrier Swier Consulting to include these cost-based elements in the index-based approach. It is AGA’s view, however, that this approach substantially reduces the meaningfulness of the comparison and unnecessarily closes off the option of examining of other productivity-based approaches where costs and prices are genuinely delinked. The AGA notes that the delinking of prices from costs for periods that are greater than currently apply would be critically important for improving incentives for efficiencies over the current building blocks approach. It is recognised , however, that this must be balanced against issues of workability and sustainability in longer periods where costs and prices might diverge significantly.

A final key point on the scope of the comparison made between models is that the alternatives are essentially assessed in qualitative terms against the existing building blocks approach. The AGA believes that following the approach of both the Productivity Commission and the WA Supreme Court judgement, the appropriate comparison to make is whether any proposed or existing form of access regulation delivers a substantial improvement on outcomes that would be achieved in an unregulated environment, and outcomes similar to a workably competitive market.<sup>30</sup>

## **Providing appropriate incentives for greenfields projects**

A key issue in the development of access pricing regulation is the future treatment of new investments, including greenfields developments such as gas distribution network extensions. This issue has been recognised by both the Productivity Commission, which urgently recommended specific measures to promote new investment, and the Commonwealth Government, which is committed to considering the adoption of these measures in the forthcoming review of the gas access regime.

The discussion paper correctly notes that scope exists for a range of greenfields distribution projects, particularly in the reticulation of some outer metropolitan and regional areas. This highlights the importance of achieving a regulatory framework that promotes the extension and expansion of gas distribution infrastructure where commercially viable.

The broad focus of the discussion paper appears to be the regulation of mature network assets, and the alternative options examined (such as the frontier method and the productivity index-based approaches) arguably are most applicable to mature or near mature network infrastructure. The discussion paper notes that some of these options can be adjusted to take into account differences between network service providers' scope of operations. An example would be an adjustment to a productivity index-based approach to account for a network service provider with a large regional area of operation, featuring a low customer density. The AGA would prefer future assessments of alternative options to at a minimum include an explicit assessment criterion of how the proposed option would impact on greenfields developments.

The AGA considers that the record of access regulation in relation to greenfields gas distribution projects in particular highlights the need for significant changes to the regulatory framework. This record includes a significant number of competitive tender processes which have not resulted in the completion of distribution network projects, and owners of a number of regional distribution networks seeking revocation of coverage under the Code to avoid significant regulatory costs which ultimately adversely impact on gas consumers and discourage the uptake of natural gas (see [Table 1](#) below).

Some key changes in this area should include the adoption of the Productivity Commission's recommendations on the options of:

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<sup>30</sup> Productivity Commission (2001), p.346

- ? access holidays for new investment – including gas distribution network extensions and augmentations
- ? adoption of a regulatory ‘truncation premium’ - to recognise the asymmetrical regulatory risks faced by new investments under access regulation.

**Table 1 - Gas Distribution Network Revocations under the National Gas Code**

Distribution network	Date of application	Length (km)	Network customers	Annual volume (TJ)	Possible regulatory costs (per five years)	Potential savings per customer	Status
Alice Springs	April 2000	30	870	110	\$250,000	\$287	Coverage revoked
Dalby	August 2000	87	2300	160	\$150,000	\$65	Coverage revoked
Roma	February 2002	21	305	20	\$150,000	\$492	Coverage revoked
Mildura	September 2002	99	890	250	\$150,000	\$169	Assessment ongoing

<b>Total</b>		237	4365	540	\$700,000		
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Finally, the AGA also considers that policy changes in this area should reflect the fact that access regulation is inappropriate for greenfields pipelines and distribution networks, which face competition from either existing pipelines or incumbent fuel sources.

The Australian Gas Association  
November 2002